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Ms Sandra Thompson
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International Accounting Standards Board
30 Cannon Street
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Dear Ms Thompson

Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement - The Fair Value Option

We welcome this opportunity to comment on the IASB's Exposure Draft on The Fair Value Option.

We do not agree with proposals of this Exposure Draft. It does not, in our view, meet its stated objectives. In particular, we are concerned that it would serve to increase rather than reduce accounting volatility. It also introduces undesirable additional complexity in the practical application of the Fair Value Option, contrary to the original intentions of the Board.

We set out below our response to the specific questions raised.

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

We do not agree with the proposals in the Exposure Draft and suggest that the requirements of the existing standard for the Fair Value Option be retained. We do not believe that the proposals of the Exposure Draft meet the stated objectives. Indeed, they may result in unintended restriction of use of the Fair Value Option in circumstances where it would be appropriate to apply it.

As explained in our response to Question 2 below, the proposals may result in an accounting mismatch between assets and liabilities of insurers in certain countries, such as the UK, where, under local GAAP, insurance liabilities are measured using current interest rates, thereby increasing accounting volatility. This is inconsistent with one of the stated objectives of the proposals.

In our view, the existing requirements of irrevocable designation and reliability of measurement already impose sufficient restrictions on the use of the Fair Value Option. We believe the additional restrictions proposed by the Exposure Draft are both unnecessary and undesirably complex. This is contrary to Board's original intention of simplifying the practical application of the Fair Value Option.

In particular, we share the concerns cited in AV4 about the introduction of a dual measurement standard in the form of a "verifiability test". Such a test may be interpreted as restricting availability of the option only to financial assets or financial liabilities, which are traded on active markets. This could result in limitations on application of the Fair Value Option in situations where unquoted assets are held to match liabilities where there is an offsetting risk position – see our comments to Question 2 below.

We further observe an inconsistency in that the proposals would result in more restrictive rules for non-derivative financial instruments (where the "verifiability test" would apply) than for derivatives (where IAS 39 requires measurement at fair value through profit and loss). This seems somewhat inconsistent given that the measurement of certain thinly traded or complex derivatives may be substantially influenced by certain subjective assumptions without the need for a "verifiability" test.

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?

(a) Portfolios of commercial & residential mortgages and privately issued bonds are often used to match liabilities under insurance contracts such as life contingent annuities or held by with profits funds to back their participating contracts.

Insurance companies are likely to consider applying the fair value option to these mortgages or private bonds in order to avoid an accounting mismatch with the measurement of the related liabilities under insurance contracts or investment contracts with discretionary participation features where, under existing local GAAP, these liabilities are valued using current interest rates. Under the proposals of the Exposure Draft, fair value through profit or loss (FVTPL) treatment would be available for such mortgages or private bonds only if they contain an embedded derivative (condition (b)(i)) or if the exposure to changes in the fair value of the mortgages or private bonds is substantially offset by the exposure to the changes in the fair value of the liabilities AND the FVTPL treatment is also applied to the liabilities (condition (b)(iii)). However, as the measurement of such liabilities will not be at fair value, condition (b)(iii) could not be satisfied.

Some insurance companies issue non unit-linked contracts, which do not contain significant insurance risk, for example annuities certain. Such companies are likely to consider applying the fair value option to these financial liabilities in order avoid accounting mismatch with the measurement of the backing assets. Backing assets could include gilts and bonds. Insurers are generally prohibited from adopting amortised cost for such assets and would prefer to achieve matching by applying the fair value option to both the assets and the contract liabilities they relate to, rather than by applying amortised cost to the liability and available-for-sale to the assets. Under the proposals of the Exposure Draft, FVTPL treatment would be available for these financial liabilities only if they contained an embedded derivative (condition (b)(i)) or the exposure to changes in the fair value of the liability is substantially offset by the exposure to the changes in the fair value of the backing assets and the FVTPL treatment is also applied to the backing assets (condition (b)(iii)).

(b) Assets such as commercial & residential mortgages and privately issued bonds may not meet the "verifiability" requirement due to the absence of a market in such instruments.
Similarly, it is not clear that the fair value of financial liabilities issued by insurance companies such as annuities certain is 'verifiable' due to the absence of a market in such instruments.

(c) Please refer to our comments above. In addition, where local GAAP currently adopts a prospective measurement basis, which considers future cash flows for liabilities under contracts issued by insurance companies, these companies may encounter practical difficulties in obtaining the historic data necessary to apply amortised cost methodologies.

Question 3
Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value 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?

Please see our comments above. We do not believe that any further limitations on the option would be 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?

We agree with the Board that, for the reasons given in paragraph BC6(a), the fair value option should be available for financial assets and liabilities that contain one or more embedded derivatives even if there is no requirement for the embedded derivatives to be separated.

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 through profit or loss but is not 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 costs 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:

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.

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 raft be applied retrospectively by restating the comparative financial statements?

We agree with the proposed transitional requirements.

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

We believe that, contrary to the anecdotal evidence referred to in BC28(a), many insurance companies which will be first-time adopters of IFRS in 2005 will opt to apply IAS 32 and IAS 39 in their 2004 comparative figures. Insurance companies are likely to opt to apply IAS 32 and 39 in the 2004 figures to avoid significant presentational differences between the figures presented for 2005 and those presented for 2004 (for example in relation to adopting deposit accounting for contracts that will be treated as financial liabilities under IAS 39).

The proposals have created additional uncertainty at a time when most insurers in Europe are in the process of implementing IFRS. We hope that following conclusion of the comment phase, the Board will move quickly to finalise its proposals so that insurers may continue their preparations in a stable environment in the short time remaining.

Yours sincerely

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