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CEA POSITION PAPER ON THE EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT: THE FAIR VALUE OPTION

21 JULY 2004

Introduction

The Comité Européen des Assurances (CEA), representing the European insurance and reinsurance sectors, is opposed to a limitation of the fair value option as included in IAS 39 issued by the IASB on 17 December 2003 and as amended on 31 March 2004. As a consequence, CEA recommends maintaining the fair value option as it was included in the IAS 39 issued on 17 December 2003.

It is more appropriate to address any regulatory concerns through very specific and limited prohibitions by the regulators, rather than by the IASB specifying certain circumstances in which such an option may be used. That way, the prohibitions could be tailored to the specific circumstances within each regulator's jurisdiction, and they could be introduced only for regulatory reporting, rather than for the financial statements.

Furthermore, we are particularly concerned by the timing of these proposals, which represent a significant change at an advanced stage of the implementation process. We also have concerns regarding the potential impact on Phase II insurance contracts of such a limitation.

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

Our key concerns relating to this exposure draft are set out below.

Key areas of concern

1. **Designation on an asset-by-asset basis** – The fair value option, if elected, shall be used for a financial asset or financial liability that meets certain conditions outlined in the exposure draft. Since the objective of the option is to mitigate the asset/liability mismatch, the application on an asset-by-asset basis, as currently proposed, is the only one which will achieve this. We would strongly oppose an alternative approach which would require adoption for all Available for Sale (AFS) assets through an accounting policy choice. This would be a major problem for insurers who need the ability to differentiate treatments between types of business, e.g. life vs. property & casualty, discretionary vs. other life products. The insurance industry draws the attention of the Board that Phase II of the insurance standard should contain a clause to reclassify out of the Held for Trading category (and more generally out of all IAS 39 asset categories) once the new measurement of insurance liabilities and investments contracts with a discretionary participating feature will be in place.

2. **Verifiability –** We fully agree that in applying the fair value option it is important that assets and liabilities be reliably measured. However, we are concerned that the proposed 'verifiable' wording in paragraph 48B could be interpreted too rigidly. 'Verifiable', particularly from an audit perspective, may have a specific sense of validation against observable markets which may not readily exist e.g. unlisted securities, bonds in developing markets. It is important that the drafting allows a sensible interpretation whilst ensuring reliable measurement and does not prevent insurance companies from seeking improvements of the measurement of their liabilities based on recognised and practised valuation techniques.

3. **Exclusion of loans and receivables -** Whilst condition (iv) excludes financial assets that meet the definitions of loans and receivables, it would appear that the intention of condition (iii) is to allow the fair value option in appropriate circumstances. The use of the fair value option in such circumstances should be clarified in IFRS 4. This is important as for example in the UK, certain liabilities (e.g. annuities) are valued on an active basis. Any changes in value are substantially offset by the commercial mortgages that back them when these are fair valued. Given that annuities are insurance contracts falling under IFRS 4 and not subject to fair valuation, it is uncertain whether condition (iii) is met in this case. Besides mortgages backing annuities, loans and deposits should not be excluded from the scope of the fair value option. For example, some insurance companies with banking business would like to use the fair value option for loans to hedge credit default swaps economically, or interest rate swaps used to create risk-free or reduced position. We would like to stress that where the fair value of these kinds of products are not reliable, they will be excluded from this option through other criteria. We question the logic of excluding loans and receivables from this option where the fair value can be determined reliably?

4. **Prudential supervisor application –** There is specific reference in the ED to the interpretation of application by prudential supervisors of banks and insurers. We are concerned that allowing local prudential supervisors to influence the application of the fair value option could lead to inconsistency of treatment between companies and territories. Whilst regulatory requirements and reporting should be determined by the regulators, we do not think it is appropriate for the role to be expanded in the context of application of accounting standards for financial reporting provided for shareholders and other stakeholders. Supervisors should not be asked to have a role in determining accounting standards, as this would not be consistent with the first purpose of financial statements. In addition, it is worth noting that this move would contradict the long-term trend seen in all jurisdictions of a split of responsibilities between auditors/accounting standard setters in charge of designing accounting standards on the one hand and supervisors in charge of controlling the companies on the other.

5. **Clarification in specific areas –**
   a) There should be explicit reference to discretionary contracts (as defined in IFRS 4) within condition ii) and iii) as it would help clarify the staff's intention to allow the fair value option for such contracts.
   b) Within condition iii) 'substantial offset' could similarly be interpreted too rigidly within an insurance portfolio context. We would prefer the words to be changed to 'partially offset'. Indeed, interest rates are a key and common element of measurement of assets and liabilities of insurance entities.

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