

12 December 2008

Sir David Tweedie
Chair
International Accounting Standards Board
30 Cannon Street
London EC 4M 6XH

Dear Sir David

I am writing in advance of the Board's meeting next week when I understand it will be considering certain issues in relation to IAS 39 and the European Commission's letter dated 27 October that is requesting changes to areas such as the fair value option, embedded derivatives, and the impairment of available for sale assets.

First, IMA¹ supports the IASB developing high quality accounting standards that are applied consistently internationally, and which maximise the transparency and comparability of accounts for our members. It is crucial to that development that the IASB follows due process. Although we appreciated that it may have been necessary to suspend due process when amendments were made to IAS 39 in October to align it with US GAAP, we believe that this was an exceptional situation and that it should not establish a precedent.

Secondly, whilst it may be appropriate to ask the IASB to accelerate its efforts, we have concerns that the Commission is requesting changes "in December to allow preparers to draw year end financial statements". These are complex areas of accounting and making changes in such a condensed time frame will almost certainly result in unhelpful reporting and have unintended consequences. This would only serve to confuse users and reduce comparability and consistency in financial reports.

Thirdly, any changes to accounting standards that give companies the opportunity to present results more favourably as would be the case with the changes requested to the fair value option and the impairment of available for sale assets could potentially mean a rush to the bottom in terms of standards and give investors concerns. In

¹ IMA represents the asset management industry operating in the UK, and includes independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. Our members are responsible for the management of approximately £3 trillion of assets invested on behalf of their clients globally. In managing assets for both retail and institutional investors, IMA members are major investors in companies and have an interest in the requirements governing how such companies prepare their accounts and the information disclosed to them as users of that information.

particular, the current crisis originated in the collapse of the leveraged loan and bank loan markets – banks still originate loans but no longer carry them to maturity. Only by exposing the “bad news” by marking such assets down to realistic prices can confidence in those markets be restored, trading resume and markets recover. The absence of realistic and transparent information is likely to mean that markets apply their own more exaggerated discounts. Investors want transparency about the current problems within financial institutions and any attempts to hide these problems will erode confidence.

Lastly, IMA supports the convergence of IFRS and US GAAP to achieve a harmonized set of global accounting standards that are comparable. However, the proposals in the Commission’s letter are inconsistent with this. On the one hand, the letter proposes changing accounting for embedded derivatives to eliminate differences between US GAAP and IFRS and on the other, proposes a change to the fair value option that increases the divergence between the two. If current IFRS is better then the IASB should maintain the difference and it should be US GAAP that changes, it should not seek to diverge further.

Undoubtedly the current credit crisis requires rapid measures by governments and regulators. However, fundamental changes in accounting should be implemented only after due process and the involvement of all stakeholders.

I trust that the above is self-explanatory but please do contact me if you require any clarification of the points in this letter or if you would like to discuss any issues further.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Liz Murrall', with a horizontal line underneath.

Liz Murrall
Director, Corporate Governance and Reporting



EUROPEAN COMMISSION

Internal Market and Services DG

The Director-General

Brussels, 27 OCT. 2008 -38626
MARKT.F.3/AD D(2008) 47947

Dear Sir David,

Subject: Further issues related to IAS 39

The ongoing financial crisis requires all parties to seek urgent solutions, which requires a creative and flexible approach. We welcome the IASB's prompt response to the ECOFIN Council of 7 October. We now expect the IASB to clarify certain practical aspects to ensure the effective implementation of the recently adopted amendments to IAS 39. Moreover, the endorsement of the IASB's recent amendments to IAS 39 and IFRS 7 on 15 October was only a first step in an ongoing process to comprehensively address accounting issues raised in the context of the financial turmoil.

At the meeting of the Accounting Regulatory Committee held on that day, the Commission indicated that it would urgently consult stakeholders with a view to identify other issues under IAS 39 and IFRS 7 that may require consideration in view of the ongoing financial turbulence. Accordingly, on 21 October, the Commission organised a meeting with European stakeholders including representatives of preparers, investors, auditors and regulators. During this meeting, participants emphasised the need to address challenges posed by the financial turmoil on an ongoing basis and identified a need for further action on some issues of importance. In view of the global nature of the financial crisis, globally coordinated solutions are preferable, while taking into account the European context and the urgency created by the ongoing financial turmoil. These solutions should be subject to appropriate due process strictly tailored to reflect the urgency of the situation.

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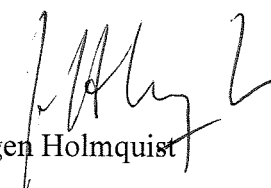
In the short-term, an urgent (before the end of this month) need for further guidance in the application of fair value in illiquid markets was identified, notably on the use of mark-to-model. In the meantime, the EU's Level 3 Committees (CESR, CEBS, CEIOPS) have issued a joint statement which clarifies the position for the national supervisory authorities in the EU. I understand that the report of the IASB's Expert Advisory Panel on fair value measurement in inactive markets will be published soon and we consider that this should be fully in line with the content of the IASB's press release of 2 October, which was well received, and should be fully consistent with the statement of the Level 3 Committees.

Moreover, we consider that three specific issues should be addressed in time for the publication of year-end results, i.e. a solution ensuring that (a) financial assets presently classified under the Fair Value Option can be reclassified into other categories and not measured at fair value, for the same reasons and under the same conditions as the assets reclassified out of the held-for-trading category; (b) clarification is provided whether synthetic CDOs include embedded derivatives; and (c) adjustments to impairment rules applicable to available-for-sale financial assets are made. These issues should be read in the light of the more detailed explanation in the annex.

I urge the IASB to work towards developing solutions as soon as possible and to devote the necessary level of resources to these tasks. This should ensure that solutions must be available in good time, i.e. in December, to allow preparers to draw-up year-end financial statements

Finally, recent developments raise broader issues related to the role of fair value accounting for financial instruments which we intend to explore further with all stakeholders as a matter of urgency. This issue should also be comprehensively addressed in the context of ongoing IASB projects. There may be a need to adjust the timetable of ongoing projects to reflect the immediate needs of the current crisis.

I look forward to continued close co-operation with the IASB to resolve these matters of mutual concern.


Jörgen Holmquist

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Enclosure: 1

c.c.: Ms. P. Berès MEP, European Parliament ECON Committee Chair,
Member States delegates in the Accounting Regulatory Committee,
Mr. F. Restoy, CESR-FIN Chair,
Mr. G. Tidström, EFRAG SB Chair,
Mr. S. Enevoldsen, EFRAG TEG Chair

ANNEX

Fair Value Option

We welcome the amendments the IASB made to IAS 39 earlier this month to permit certain reclassifications out of the held-for-trading and available-for-sale categories. The impact of these changes is limited to instruments that have to date been categorised as held-for-trading or available-for-sale. Many of our biggest financial institutions (including many insurers) have used the fair value option to eliminate or significantly reduce measurement mismatches that would otherwise have arisen between assets and liabilities or to ensure that assets and/or liabilities managed on a fair value basis are measured on that basis. However, the virtual disappearance of some markets may have had an impact on the way these instruments are managed. Currently, following IAS 39, a decision is made on initial recognition to apply the Fair Value Option and no subsequent change in the classification is permitted.

It is important that financial instruments currently classified under the Fair Value Option can be reclassified into other categories and that are not, or no longer, measured at fair value. This should be possible due to the same reasons and under the same conditions as the assets reclassified out of the held-for-trading category.

Embedded derivatives

In relation to embedded derivatives there is a difference in treatment under IFRS and US GAAP that needs to be addressed. IAS 39 AG 30 (h) has been consistently interpreted as requiring separation of an embedded credit derivative in an investment in a “synthetic CDO”. As a consequence, European companies using IFRS have to account for these embedded derivatives separately and measure them at fair value with changes in fair value recognised in the profit and loss account, unless the host contract is classified as at fair value through profit or loss.

In contrast, US GAAP does not require an embedded derivative to be recognised separately: paragraph 14B of FAS 133 (inserted into FAS 133 by FAS 155) states that changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative contracts) that represent the assets or liabilities that are held by the issuing entity shall not be considered to be an embedded derivative. Thus, as a result, the credit risk component of synthetic CDOs in US GAAP would not need to be recognised separately. If the synthetic CDO is classified—or reclassified—in an accounting category measured at amortised cost, its credit risk component would not need to be measured at fair value. It would be submitted only to credit risk impairment tests.

Urgent action is needed to clarify whether, under IAS 39, "synthetic CDOs" include embedded derivatives.

Impairment of Available For Sale (AFS) items

Debt securities

In IAS 39 there are differences in how an impairment loss is recognised depending on whether the debt instrument is accounted for as an AFS instrument at fair value through equity or at amortised cost. If there is objective evidence that an asset is impaired, in the first case the impairment recognised in profit and loss corresponds to the difference between its carrying value and fair value, and in the latter case it corresponds to the difference between its carrying value and recoverable amount determined on expected future cash flows.

However, under current market circumstances, fair values are changing because of general market factors, including illiquidity, as well as changing expectations of future cash flows on specific debt instruments, which means that when a 'fair value impairment test' is being applied, the losses that are being recognised in the income statement are greater than the change in recoverability of the underlying debt instrument. In effect, changes in liquidity risk are being included in impairment losses.

The approach for available for sale debt securities should be changed. Impairment losses should be determined similarly to the way impairment is recognised for held to maturity instruments and loans and receivables; the balance of the fair value decline in excess of incurred credit losses would be maintained in equity. Thus, only credit losses would result in impairment losses in the income statement.

Equity instruments

Under the existing requirements under IAS 39, impairments of available for sale equity instruments are required to be recognised in the income statement, but reversals of impairments through the income statement are prohibited. This has the undesired effect that entities are being required to recognise in their income statement some losses on their equity investments, knowing that if the price subsequently recovers they will not be able to recognise gains in the same statement. This apparent lack of balance is very concerning.

There should be a possibility of reversing impairment losses not only for debt securities, but also equity instruments.