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NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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Dear Sir David and Members of the Board:

Thank you for the opportunity to comment on the Amendments to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option. On behalf of the International Accounting Standards Working Group (IASWG) of the National Association of Insurance Commissioners (NAIC), I am pleased to provide you comments in response to your Invitation to Comment.

<u>Invitation to Comment</u>

Our comments have been organized in a manner consistent with the questions outlined in the IASB's Invitation to Comment. As stated in the IASWG comment letter dated October 14, 2002 in response to the IASB initial Financial Instruments Project exposure draft, it is the preference of the IASWG if the 'fair value option' was removed from the International standard. Notwithstanding that position, following are our responses as specifically requested by the Invitation to Comment on the proposed amendments to IAS 39.

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

Response:
The IASWG agrees with the exposure draft amendments that propose to limit the fair value option. Furthermore, the IASWG strongly supports the inclusion of 'verifiability' in determining whether a financial asset or financial liability qualifies for the fair value option.

Even though IAS 39 excludes insurance contracts from the scope, a reporting insurance entity could elect the fair value option in accordance with paragraph 9(b)(v) of the proposed IAS 39 amendments. Although insurers could invoke the fair value option, it is our opinion that the majority of insurance contract liabilities would be unable to currently meet the 'verifiability' requirement included within the standard. Only insurers reporting in countries with stated directives for the determination of fair value could be considered to have 'verifiable' insurance contract liabilities. Due to this limitation, the IASWG suggests that the IASB consider whether this option should be restricted to insurers that have a local GAAP directive for reporting insurance contracts at fair value until phase II of the Insurance Contracts Project is complete.

Although the IASWG agrees with the intent to place restrictions on the fair value option as reflected in the amendments, it is the opinion of the IASWG that the proposed revisions to IAS 39 are not clear and may inherently prevent the consistent application of this standard among companies. For example, one company may conclude that a financial asset or financial liability could be valued in accordance with the fair value option while a different company with similar assets or liabilities may conclude that they are not eligible under the fair value option criteria. If the IASB has identified specific financial assets or financial liabilities that would not qualify for the use of the fair value option, we would recommend an appendix identifying those items as examples.

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?

Response:
After studying the proposed exposure draft revisions, it is our understanding that insurance contract liabilities that are not currently measured at 'fair value' in accordance with directives from existing local GAAP would be ineligible for the fair value option. If an insurer, without local GAAP guidelines, was to implement a fair value assessment for an insurance contract liability, the method and assessment must be considered arbitrary inasmuch as there have been no standards thus established relative to *how* to calculate the fair value of insurance liabilities. Under the proposed amendments to IAS 39, such arbitrary fair value assessments for insurance contract liabilities would not satisfy the 'verifiability' requirement of the fair value option. Insurance contract liabilities, without measurement directives from the IASB or local GAAP, would not meet the 'test' identified in paragraph BC25 of the Basis for Conclusions in that several independent and knowledgeable observers would be unable to estimate a 'fair value' and arrive at approximately the same amount.

To prevent confusion in the application of this standard, the IASWG recommends that the Board clearly indicate that insurance contract liabilities are excluded from the fair value option unless formal guidelines for calculating a 'fair value' measurement have been adopted by local GAAP or by the IASB.

The IASWG notes reference within the amendments to IAS 39 that insurance supervisors may have the ability to oversee the application of the 'fair value option' and on how to determine 'fair value'. Unless formal statutory or local GAAP directives regarding fair value measurement have been established for a specific country, insurance supervisors have not likely established a method or identified the required components to calculate a 'fair value liability' for insurance contracts. The IASWG is concerned that this reference will imply a need for insurance supervisors to develop a fair value model for insurance contract liabilities.

Furthermore, the inclusion of the 'supervisory' clause in paragraph 9 appears inconsistent with the commitment of the IASB to issue standards for financial statements that are strictly 'general-purpose' in nature. This clause, although not providing additional powers to supervisory bodies, does suggest that supervisory officials should be contacted and special accounting guidelines should be considered when determining the 'fair value' of financial assets and financial liabilities.

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?

Response:
The first concern identified in paragraph BC9 acknowledged the ability to apply the fair value option to financial assets or financial liabilities subjectively, therefore creating an opportunity for companies to inappropriately impact profit or loss. By restricting the fair value option to financial assets and financial liabilities that are verifiable, the concern of improper favorable fair value assessments has been reduced.

We reiterate our previous responses regarding IAS 39 that our concerns would be considerably alleviated if the fair value option would only pertain once a fair value measurement method for insurance contract liabilities has been formally adopted under local GAAP or by the IASB. As stated in our response to question two, unless specific directives have been established for the calculation to determine the 'fair value' of insurance contract liabilities, we do not believe that insurance contract liabilities meet the 'verifiability' criteria for fair value reporting.

The third point in paragraph BC9 identifies the concern attributed to recognizing gains or losses in profit or loss based on changes in a reporting entity's own creditworthiness. Although an additional disclosure is required to report the change in fair value for financial liabilities not attributable to changes in a benchmark interest rate, our concern that the face of the financial statements may represent a misleading financial performance has not been alleviated. Inasmuch as the primary financial statements are often the main focus of analysis, the prospect of expanded reflection of fair value-based information incorporating adjustments for changes of creditworthiness of the reporting entity would tend to confuse statement users notwithstanding the expanded disclosure.

In any event, the IASWG disagrees with the previous IASB decision to include consideration of 'ones own creditworthiness' within the assessment of fair value.

Although these standards eliminate some concerns, it is still the IASWG position that the accounting treatment reserved for 'held-for-trading' securities (i.e., fair value accounting) should be reserved for those instruments that reflect active and frequent buying and selling and/or an objective of generating profits on short-term differences in price. Securities that are intended to be held-to-maturity should be measured at amortized cost.

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 recognizes 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?

Response:
With the exception of concerns previously communicated in our response to the insurance contracts exposure draft regarding the separation of embedded derivatives from insurance contracts, the IASWG does not object with the proposal to grant the 'fair value' option to all contracts with embedded derivatives regardless if they are required to be separated 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 amortized 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 amortized cost.

(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognized 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 recognized.

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 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?

Response:
The IASWG does not have any comments on the transitional requirements for the IAS 39 fair value option.

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

Response:
As the IASWG actively monitors the IASB and all released standards and exposure drafts, we have concerns with the recent trend of the IASB to reevaluate international standards immediately after their initial adoption and release. In accordance with this trend (illustrated by the recent exposure drafts of IAS 39, IFRS 3, and IAS 19), we are concerned that this continued process may generate an inappropriate perception regarding the Board's deliberative process. Furthermore, these immediate releases might imply that the Board has been swayed by political considerations.

The IASWG currently attributes these accounting 'corrections' as the result of the rushed completion of released standards. Now that the March 31, 2004 deadline has passed and the IASB has committed to fully consider all aspects of a standard before public release, we would anticipate the need to issue immediate amendments addressing unresolved issues or 'altered' decisions to be mitigated.

We appreciate the opportunity to comment on the proposed revisions to IAS 39 regarding the fair value option. Should you have any questions, please contact me at (501) 371-2667, or Julie Gann (NAIC Staff) at (816) 783-8125.

Sincerely,

Mel Anderson
Chair, NAIC International Accounting Standards Working Group

Background and NAIC Process

Formed in 1871, the NAIC is a voluntary organization of the chief insurance regulatory officials of the 50 states of the United States of America, the District of Columbia, American Samoa, Guam, Puerto Rico and the Virgin Islands. The mission of the NAIC is to assist state insurance regulators, individually and collectively, in serving the public interest in a responsive, efficient and cost-effective manner, consistent with the objectives of its members.

In fulfilling this mission, the NAIC has developed significant experience and expertise in the development of meaningful accounting principles for use in the financial statements of insurance enterprises. The NAIC has the responsibility to establish and interpret statutory accounting principles. The codification of statutory accounting principles by the NAIC produced a comprehensive guide for use by insurance departments, insurers, and auditors.

The fundamental concepts upon which these principles were promulgated are conservatism, consistency and recognition. While these principles are not identical to the framework used by the IASB, which govern general-purpose financial statements, the NAIC has developed expertise with general-purpose financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). The NAIC reviews all U.S. GAAP pronouncements to determine their relevance for statutory accounting purposes.

These comments have been prepared by the IASWG of the NAIC. As part of the NAIC's due process procedures, these comments have also been shared with interested parties to the IASWG, all of whom were given an opportunity to contribute to the IASWG's deliberations of these issues. However, the IASWG does not wish to imply that these comments are shared by all of the IASWG interested parties.