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Dear Sandra

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

This is the response of Aviva plc to the exposure draft on proposed amendments to the 'fair value option'. As the world's seventh largest insurance group and the largest insurer in the UK, we are pleased to have the opportunity to comment on the proposals that will have a significant impact on financial services enterprises.

We are strongly opposed to the proposal to restrict the fair value option. We believe such restrictions are inappropriate when there is a 'reliable' fair value measure. The option is required to give an economic representation of the value of assets on the balance sheet.

We supported the June 2002 revision to IAS 39 as it enabled natural hedges to be appropriately reflected in the financial statements. The proposal to restrict the fair value option is rules based and focuses on anti-avoidance. We believe the IASB is setting a dangerous precedent by amending accounting standards to address the concerns of banking regulators, particularly where this has an inadvertent adverse impact on third parties such as the European Insurance Industry.

Appendix A outlines our particular concerns in respect to commercial mortgages backing annuities, 'verifiability' and 'substantial offset'. Appendix B responds to the specific questions in the exposure draft

We welcome the efforts made by the IASB to respond to the concerns that were expressed by the insurance industry when the proposal to restrict the fair value option was announced. In particular, this includes the ability to designate assets at fair value through profit and loss on an individual asset by asset basis. However we would encourage the IASB to reject the current proposals in the exposure draft.

Yours sincerely

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Appendix A – Aviva key concerns with proposals

Summary

In summary the proposed restrictions to the fair value option will exacerbate rather than decrease volatility for insurers. This seems to contradict the intention of the IASB which has sought to enable insurers to measure assets that back insurance liabilities and the liabilities themselves on a consistent basis, using current market interest rates and fair values. The current fair value option has not led to manipulation of profits and thus we consider the proposed restriction unnecessary and inappropriate.

Our key areas of concern are set out below:

Commercial mortgages backing annuities

We consider that any assets which are 'verifiable' and represent an economic hedge, including loans and receivables, should be allowed to be 'at fair value through profit & loss account'. We believe that commercial mortgages backing annuities can continue to be fair valued in accordance with paragraph 9(b) iii of the proposed amended guidance, since the exposure to fair value movements in the mortgages is substantially offset by exposure to fair value changes in annuities.

However the wording in the ED that follows the four options presented is not helpful for insurers - it states that *"In the case of options ii and iii, if either the financial asset or financial liability is to be designated at fair value through profit or loss, the identified related financial asset or financial liability shall also be <u>measured</u> at fair value through profit or loss either by designation or, when the definition is met, by classification as held for trading."*

Annuities are measured at fair value through profit and loss in accordance with IFRS 4 and not by designation or classification as held for trading. They are valued on an active basis, but since they are insurance contracts falling under IFRS 4, it is uncertain whether this 'measured' condition is met.

From our discussions with IASB Board members and staff we do not believe it was the intention of the IASB to restrict the fair value option in respect of this type of business. This is further supported by the IASB's March 04 update which notes "*The Board considered whether the third category should apply only when the financial asset or liability is measured at fair value. The Board tentatively decided that the category should not be restricted in this way."*

The wording of any fair value restriction should be clarified in this respect.

A further problem arises in respect of financial assets that are not substantially offset at inception but are accumulated to make up a portfolio before the economic hedge is put in place. An example is our equity release mortgage portfolio. Designation at fair value through profit or loss should be allowed at inception of the "substantial offset relationship" to allow such natural hedges to be effective.

Verifiable fair value

It would appear that the IASB is seeking to introduce a higher test than we have previously had to pass, since any asset that is to be designated at fair value through profit and loss must have a verifiable fair value. However we believe this additional guidance is confusing since it would not

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be appropriate under generally accepted accounting practice and as set out in the framework, to include assets or liabilities in financial statements if they cannot be reliably measured. In our view the ability to verify a fair value is part of the process of determining whether the asset or liability can be reliably measured.

Substantial Offset

We understand the substantial offset test has been put in place to ensure that natural hedges can continue to be effective by the use of the fair value option. However we are concerned that it may be open to too restrictive an interpretation with the result that the fair value option will not be available for all assets and liabilities that are part of an economic or natural hedge.

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Appendix B – Specific response to questions

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 this Exposure Draft. The proposed restriction of the fair value option is a retrograde step and it is likely to result in increased volatility in the income statement which will not accurately reflect the economic reality of the situation.

We do not support the introduction of the concept of verifiability. In our view this will lead to confusion since fair values should already be verifiable if they are to be capable of reliable measurement.

The concept of substantial offset creates another arbitrary limit in addition to those required by the hedging rules of IAS 39. Also it is clear that different interpretations are already emerging. We are concerned that the concept of substantial offset is open to too restrictive an interpretation.

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?

We have previously specifically raised our concerns regarding commercial mortgages backing annuities. Certain financial assets are accumulated to form a portfolio before the substantially offsetting hedging relationship is established. The restriction to the fair value option would mean that such financial assets which meet the definition of a loan or receivable could no longer be designated at fair value through profit or loss upon initial recognition. This could lead to increased volatility in the income statement despite the existence of a substantially offsetting natural hedge.

These are significant concerns, which we are happy to discuss and provide further information on.

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?

The concerns raised in BC9 should already be address by the influence of the framework, IAS 1 and the interaction of management and their auditors.

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In our view it would not be appropriate under the framework to include assets or liabilities unless their value can be reliably measured. The ability to verify a value is part of the process of determining whether that asset or liability has been reliably measured.

It is up to management and their auditors to ensure the accounting policies adopted are the most appropriate in accordance with IAS 1. There is no evidence in the insurance industry of the fair value option being used to manipulate profits. Even if this was the case this should be address by the audit process and not by the introduction anti-avoidance amendments to accounting standards.

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 the application of accounting standards for financial reporting provided for shareholders and other stakeholders.

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 believe the proposal in paragraph 9(b)(i) is appropriate.

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

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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 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?

We do not consider it appropriate to require the application of this proposed amendment for periods beginning on or after 1 January 2005. The IASB committed to a stable platform of standards by March 2004. We are too far down the track of IFRS implementation to make changes at this late stage.

Question 6

Do you have any other comments on the proposals?

The IASB has sought to address the concerns raised by prudential supervisors by restricting the overall use of the fair value option and offering a limited number of exceptions. We consider any regulatory concerns regarding should be address through specific prohibition. We are concerned that the potential precedent of undue influence of regulators in accounting standards which are designed for use in the preparation of financial statements for shareholders and other stakeholders is inappropriate.