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

Old Mutual response

2 July 2004

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

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

In our comment letter dated 17 October 2002 Old Mutual welcomed the fair value option. We do not agree to the proposals in the Exposure Draft to amend it. We believe that the IASB should revert back to the original proposals in IAS39 that permitted the fair value through profit or loss account treatment to be adopted without restriction.

Paragraph 9b(iii) permits the use of the fair value option if the exposure to changes in the fair value of the financial asset or financial liability is substantially offset by the exposure to the changes in fair value of another financial asset or liability. Permitting the fair value designation without restriction allows Old Mutual to match the accounting treatment for the majority of the Group's financial assets and insurance liabilities, which are carried at fair value. At the very least the option should be extended to include financial assets offsetting insurance liabilities (e.g. insurance policies backed by mortgage or policy loans).

We disagree with the proposal to require that fair values are verifiable where the option is used rather than the lesser standard of *reliably measured* applicable otherwise. The *verifiable* notion does not exist in other areas of measuring fair values in IFRS, and it would be inconsistent to introduce it.

In addition, the definition of a *verifiable* fair value as defined in paragraph 48B is framed with financial assets in mind rather than financial liabilities. Old Mutual incurs financial liabilities on the investment contracts it writes. The exposure to changes in fair value of these financial liabilities is substantially offset by the exposure to changes in fair value of a portfolio of financial assets, acquired for that purpose, and therefore qualify under paragraph 9b(iii) for designation as at fair value through profit or loss. The fair value of these financial liabilities is based on the margins emerging on the financial assets, so that a movement in the value of the assets is substantially offset by the movement in the value of the liabilities (for an example see section 1.2 and the answer to Question 2). If the fair value of the financial liability or linked assets are not considered verifiable then there is a mismatch of accounting treatment. We believe that the verifiable test should not be required if the requirements of 9b(ii) or 9b(iii) are met, or alternatively revisions are made to the *verifiable* definition.

The scope paragraph of IAS 28 *Investments in Associates* excludes investments in associates held by a variety of investment vehicles including investment-linked insurance funds and venture capital organisations. Under IAS28 paragraph 1 such investments shall be measured at fair value under IAS39 with changes in fair value recognised in profit or loss in the period of the change. How should an entity account for investments in unlisted associates held by investment-linked insurance funds or venture capital funds, if their fair values are deemed unverifiable? In this regard the proposed amendments to IAS39 are in conflict with IAS28. The limitation to the fair value option seems in conflict with the underlying reason for the IAS 28 option that fair value information is considered by the

Board to be often readily available because fair value measurement is a well-established practice in the venture capital entities, mutual funds and unit trusts (see BC 7 of IAS 28).

Old Mutual does not support the reference to prudential supervisors and other regulators because such a reference could lead some to believe that regulators have authority to amend or overrule IFRS for the purposes of financial reporting. While we note that the IASB stresses in its Basis for Conclusions that this is not the case, we do not support the reference to supervisors because Old Mutual strongly believes that there should be a clear dividing line between IFRS and prudential requirements.

1.2 ***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?

The amendments to paragraph 9 of IAS39 require that, where a financial asset or liability is designated as a financial asset or liability at fair value through profit or loss, and is contractually linked to the performance of another financial asset or liability, that related financial asset or liability must also be designated at fair value through profit or loss. Where an insurer has liabilities under insurance contracts and contracts with discretionary participation features linked to the performance of specific assets, it is unclear whether these assets can continue to be designated at fair value through profit or loss. The reason for this is that the liabilities under these contracts cannot currently be fair valued (as accepted by the IASB in IFRS4), therefore it is uncertain if the related assets can continue to be fair valued through profit or loss.

An example of a financial instrument where the IASB needs to add further clarity to the definition of a *verifiable* fair value for a financial liability is in respect Old Mutual's term certain annuities. Old Mutual currently attempts to match the cash flows of the annuity payments (which are clearly known) as closely as possible with fixed interest stock (government gilts). A weighted average current yield of the fixed interest stock is used as the valuation interest rate for the liabilities. So a movement in the value of the assets is substantially offset by the movement in the value of the liabilities (or vice versa). The value of the assets is clearly verifiable, since the government gilts are traded. But what proof is now needed or how does one prove that the value of the liabilities is verifiable? Further clarification is required.

1.3 ***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?***

Old Mutual is content with the original fair value option and does not think any further limitations on the option would be appropriate.

1.4 ***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?

Since we are in general supportive of the current fair value option because it eases the application of IAS 39 and allows the reduction of accounting volatility we do not favour any (further) restriction. As regards our comments on the proposed limitations, we refer to our response to question 1.

1.5 ***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 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?

Old Mutual supports the pragmatic approach as regards the transitional requirements – i.e. no retrospective application when an entity changes the measurement from *at fair value through profit and loss* to amortised cost.

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

We have no other comments on the IASB proposals.