21 July 2004

Ref: 7/060

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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David,

IAIS comments on the Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement – The Fair Value Option*

Thank you for giving us the opportunity to comment on the Exposure Draft distributed in April 2004. On behalf of the International Association of Insurance Supervisors (IAIS) members, we are pleased to provide you with the following comments.

The IAIS is an international organisation composed of insurance supervisors from more than one hundred and twenty jurisdictions. One of the main objectives of the IAIS is to set standards that insurance supervisors around the world may adopt within their jurisdiction. An important part of this objective is to define a common basis for regulatory reporting by insurance enterprises, so that supervisory financial reports are consistent and system efficiency can be enhanced.

Our interest in the development and implementation of high quality financial reporting standards has been on record for some time, especially in view of the acute need for a single, globally recognised and accepted approach for insurance liabilities. We have also provided significant input to those IASB proposals that will most influence the overall accounting model for regulated insurance enterprises in the interest of providing a meaningful, economically sound portrayal of these enterprises' activities to the external markets.

The overall objectives of prudential regulators are not significantly different from those of the markets, in that both are interested in a true representation of underlying financial performance and an assessment of the solvency of insurers. As such, we believe that well-crafted external financial reporting standards should be the objective we both strive to achieve.

The following comments cover the Exposure Draft and the Basis for Conclusions on the Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement - The Fair Value Option* issued in April 2004 by the International Accounting Standards Board.

Our comments are limited to areas where the members of the IAIS Accounting Subcommittee reached a general consensus. As such, we have not provided detailed responses to the specific questions listed in the exposure draft. It is expected that some of the IAIS members' jurisdictions will provide separate or additional comments in response to some or all of the questions, based on the issues, impact or circumstances relevant to their particular jurisdiction.

We believe that the proposed amendments to IAS 39 do not effectively meet the objectives stated by the Board of addressing the use of inappropriate fair values, reducing volatility in profit or loss and avoiding of gains and losses in profit or loss arising from changes in an entity's own creditworthiness.

There is a consensus among supervisors that assets and liabilities should be measured on a consistent basis, in order to avoid the creation of an artificial volatility in equity (e.g. the so-called "mismatch issue"), to the extent that it does not damage the understanding, comparability, relevance and reliability of financial statements. Given the fact that there is still no consensus on the measurement of insurance contract liabilities and that, consequently, IFRS 4 transitionally allows the application of current national accounting regulations, jurisdictions find themselves in two types of situations, both of which cause concern.

(i) First, in jurisdictions where most of the assets and liabilities are measured at market value or at fair value, in compliance with local standards, supervisors expressed concerns about the consequences of the proposed amendments as certain financial instruments may no longer be eligible for recognition at fair value under IAS 39. In these jurisdictions' view, the restrictions proposed by the Board would generate a mismatch between assets and liabilities that did not exist previously.

(ii) By contrast, other jurisdictions require that insurance liabilities are measured at cost, as well as certain categories of financial assets. The view of these jurisdictions is that the scope of the potential use of the Fair Value option remains too wide as a significant proportion of an insurer's technical liabilities would appear to be eligible for the option, due to the inclusion of the category defined at paragraph 9 b) (i)[1]. Supervisors in these jurisdictions believe that, as a consequence, the possibility for insurance companies to use this option would damage both comparability and reliability of financial statements.

A consensus was also reached on the two following specific issues.

The 'verifiable' concept

We believe that the introduction of the 'verifiable' concept could be very confusing. The proposed amendments (paragraphs 9(b) and 48B) introduce an idea whereby financial instruments eligible for the option of fair value 'by designation' have to meet stricter criteria than 'available for sale' or 'held for trading' assets. The 'verifiable' criterion, applicable to the 'by designation' class, requires that "the variability in the range of reasonable fair value estimates [….] is low". No such qualification applies to the 'reasonable estimates' of fair value for the 'available for sale' and 'held for trading' categories. One can infer therefore, for these categories, that fair value can be reliably measured even where the variability in the range of reasonable estimates is not low (i.e. it may be high). This is an anomaly. We

[1] ED, paragraph 9 b) (i): "The item is a financial asset or financial liability that contains one or more embedded derivatives as described in paragraph 10, whether or not paragraph 11 requires the embedded derivative(s) to be separated."

are convinced that all assets and liabilities measured at fair value should be subject to the same basic reliability requirements, and that any instrument which can be 'reliably measured' must actually meet the 'verifiable' criterion, as defined by the IASB.

<u>The reference to supervisors</u>

The Exposure Draft, in paragraph 9 b), makes an explicit reference to supervisors[2]. We believe this paragraph could be misinterpreted and therefore could be somewhat confusing, as no other IAS/IFRS mentions either regulators or supervisors. Indeed, one could infer from this sentence that supervisors are made responsible by the IASB for overseeing the application of the IAS/IFRS. Conversely, this single occurrence could also be interpreted as limiting the scope of the supervisor's task, regarding IFRS issues, to the application of the Fair Value option requirements. As a consequence, we suggest that this explicit reference should be deleted.

If there is any way in which the IAIS Accounting Subcommittee can assist the Board further, please do not hesitate to contact Mr Luc Cardinal at the IAIS Secretariat (tel: 41 61 280 8119; fax: 41 61 280 9151, email: luc.cardinal@bis.org).

Yours sincerely,

Manuel Aguilera
Chairman, Executive Committee

Tom Karp
Chairman, Technical Committee

cc: Mr. Luc Cardinal

[2] Exposure Draft, paragraph 9 b): "For entities subject to prudential supervision such as banks and insurance companies, the powers of the relevant prudential supervisor may include oversight of the application of these requirements and of relevant risk management systems and policy."