Danish Insurance Association

Sir David Tweedie
International Accounting Standards Board

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The Fair Value Option – Comments by the Danish Insurance Association on Exposure Draft of Proposed Amendments to IAS 39

Dear Sir Tweedie,

In the Danish Insurance Association we have studied the proposed amendments to IAS 39 and would like to give our answers to some of the questions raised.

As you are probably aware, the Danish Insurance Association fully supports the process of reaching a transparent, coherent and high quality set of accounting standards in the EU area based on the work of the IASB. From our point of view a guiding principle upon which such high quality standards must rest is that of fair value. Although the concept of fair value might give rise to some problems of measurement where efficient markets are lacking, the benefits of building international accounting standards on fair values, market values or best estimates in our view by far outweigh potential disadvantages.

Our general approach to the proposed amendments to IAS 39 must be seen in this light. We are not convinced of the necessity of limiting the fair value option. We recognise that the use of fair value measurement might introduce volatility into profit or loss when fair values are not systematically applied to all items in the accounts. However, such volatility seems not to be of a real economic nature. In many ways, we would tend to agree with those Board members who voted against the publication of the Exposure Draft.

Given, however, that is was decided to publish the Exposure Draft, we would like to respond to some of the questions raised:

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

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We are concerned about the introduction of the "verifiable" notion, which supposedly – according to BC 25 – represents a stricter test than that of "reliable" measurement.
Moreover, we see no need for the introduction of a criterion for the designation of any asset or liability to fair value measurement which is stricter than the reliability criterion.

In particular, we are concerned that the introduction of the verifiability criterion may limit the possibilities of measuring investments in unlisted shares, venture capital entities, mutual funds and unit trusts etc. at fair values according to the reliability criterion. Danish life insurance companies and pension funds are increasing such investments at present to alleviate problems of raising capital for small companies.

Such investments are often reliably measured at estimated fair values through the use of a genuine model technique. If the criteria introduced by the proposed amendments to IAS 39 should introduce as a precondition for fair value measurement that the measurement of each underlying company in such investments is valued separately, such investments would be effectively impossible.

This issue will be further elucidated when investing in fund of funds. One fund invests in several other funds, which again have invested in several individual companies. The verifiable criterion requires transparency and investors will have to follow up on each individual company at the lowest level. If so, this will definitely be time consuming and costly in relation to the marginal investment in each of the individual companies. As stated earlier one could take advantage of genuine model technique in the annual reports, ex. EVCA-standards, from the fund of funds, but before they are published and recognised in investors reports, there will be a lag of time up to one year. Such time lags should not stand in the way of satisfying the concept of "fair value through profit and loss."

If the fair value option can not be used for the assets mentioned above, because of the proposed stricter verifiable criterion, this will imply, that they are classified as available-for-sale assets, meaning that they will still be measured at fair value, since they are in compliance with the reliable criterion, but with gains or losses recognised directly in equity (except for impairment losses and foreign exchange gain and losses). This seems inconsistent and we shall object to this, especially since removing the option, for the available-for-sale assets to recognise gains and losses through profit or loss in the former IAS 39, was justified by the introduction of the fair value option. Further more, in Denmark, policyholders rights would be changed because of the so-called principle of contribution, in which with-profits life insurance contracts determines policyholders rights on the basis of accounting profits.

We therefore strongly urge the IASB to modify the proposed amendment so that the reliability criterion is not supplemented by any stricter test.

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 48 B) and if not, why not?
c) How would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

Danish life insurance companies and pension funds have the possibility of making loans to the policyholders based on the value of their accumulated benefits. The loans are quite similar to bank loans but are secured with those accumulated benefits. Such loans are excluded from the fair value option by the proposed amendments.

Also, Danish insurance companies might invest in personal debt instruments, primarily linked to the value of private housing. It is debatable whether this financial instrument will be eligible for the option. The same uncertainty applies to investments in some unquoted bonds.

The corporate bond market operates at different levels. One level can be the issuer issuing the bond through a recognised exchange market. Another level is that the issuer sells the bond directly to the investor. The last transaction will have no "quoted market price" and might be categorised as "loans and receivables". But the corporate bond is very closely related to the official bond rates, except for the credit rate of issuer. We assume the transaction can be evaluated, according to 48B(b), by compensating for the lower credit rate and taking into account the observable bond prices observed in the market. Getting verification of the size of the lower credit rate can be difficult. On the contrary, estimating the size of creditworthiness on the company will give you a reliable and satisfying result.

We do think that these financial instruments can be verifiably measured and should be fair valued. There is no need to limit the use of the fair value option for these instruments. Estimated fair values provide the best economic details of the value of the instruments. The information value of the accounts would be limited if these financial instruments were not measured at fair value. Even more important, policyholder rights would be changed because of the Danish so-called principle of contribution, as mentioned above.

Question 3: Do the proposals in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC 9? If not, how would you further limit the use of the option and why?

As already explained, we have some reservations as to the very proposed limitations of the fair value option. In the light of this, it is very important for the Danish Insurance Association to stress that the use of the fair value option should not be further limited.

Sincerely Yours

Peter Skjødt

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