CL 60

RESPONSE OF THE ASSOCIATION OF BRITISH INSURERS (ABI) TO THE IASB EXPOSURE DRAFT - AMENDMENT TO IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT: THE FAIR VALUE OPTION

1 EXECUTIVE SUMMARY

1.1 We do not agree with the proposals in the Exposure Draft. In our view IASB should retain the existing provisions of IAS 39 relating to the fair value option.

1.2 We are concerned that regulators have been permitted to bring about changes on accounting issues that should be the sole prerogative of IASB.

1.3 We disagree with the proposal to require fair value to be verifiable where the fair value option is used rather than reliably measured.

1.4 We do not agree with the proposal to exclude loans and receivables from financial assets to which the fair value option can be applied. This may result in increased volatility where the fair value option cannot be applied to loans and receivables held to match insurance liabilities the valuation of which is measured under UK GAAP by reference to current interest rates

2 ANSWERS TO THE SPECIFIC QUESTIONS RAISED

(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 the Exposure Draft. We believe that IASB should revert back to the existing provisions of IAS 39 that permit the fair value through the profit and loss account treatment to be adopted without restriction.

We are unhappy that IASB has given way to pressure from regulators in adjusting a standard that it had previously agreed. Regulators have cited certain abuses that needed to be addressed but are they aware of situations where these have been a serious problem in practice?

We also disagree with the proposal to require that fair value is verifiable where the option is used rather than the lesser standard of “reliably measured” applicable otherwise.

This gives rise to an undesirable dual measurement standard by adding a second threshold for fair value measurement. In doing so it raises serious questions about fair value measurement in general. If there are financial assets where the fair value is deemed not appropriate there may be little future for fair value measurement in areas like Phase II of the Insurance Contracts standard.

On the other hand we welcome the fact that the fair value option can be applied on an asset-by-asset basis to items that are financial assets but we question the exclusion of loans and receivables from this provision. If insurers are unable to apply the fair value through profit or loss (FVTPL) option to loans and receivables held to match insurance liabilities, which are valued using current interest rates under local GAAP, this may result in increased volatility in insurer's results. The comment in BC15 does not recognise that insurers use loans and receivables to back insurance liabilities.

(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?

(a)(i) Portfolios of commercial and residential mortgages and privately issued bonds are often used to match liabilities under contracts such as life contingent annuities.

Insurance companies are likely to consider applying the fair value option to these mortgages or private bonds in order to achieve partial matching with the valuation of the insurance liabilities that, under existing local GAAP, are valued using current interest rates. Under the ED's proposals FVTPL treatment would be available for such mortgages or private bonds only if they contain an embedded derivative (condition (b)(i)), or the exposure to changes in the fair value of the mortgages or private bonds is substantially offset by the exposure to the changes in the fair value of the insurance liabilities **and** the FVTPL treatment is also applied to the insurance liabilities (condition (b)(iii)). However as insurance liabilities will not be measured at fair value condition (b)(iii) could not be satisfied. Notwithstanding the above it is also not clear whether the fair value of a mortgage or private bond portfolio would satisfy the 'verifiability' requirement due to the lack of a market in such instruments.

(a)(ii) Non unit-linked contracts issued by insurance companies, which do not contain significant insurance risk, for example annuities certain.

Insurance companies are likely to consider applying the fair value option to these financial liabilities in order to achieve partial matching with the backing assets. Backing assets could include gilts and bonds. Insurers are generally prohibited from adopting amortised cost for such assets and would prefer to achieve matching by applying the fair value option to both the assets and the contract liabilities they relate to, rather than by applying amortised cost to the liability and available-for-sale to the assets. Under the ED's proposals FVTPL treatment would be available for these financial liabilities only if they contained an embedded derivative (condition (b)(i)) or the exposure to changes in the fair value of the liability is substantially offset by the exposure to the changes in the fair value of the backing assets and the FVTPL treatment is also applied to the backing assets (condition (b)(iii)). However the 'verifiability' condition would also have to be met. It is not clear that the fair value of such instruments is 'verifiable' due to the absence of a market in such instruments.

(b) It is unclear whether sufficient consensus will be reached to allow consistent interpretation of the distinction between a 'verifiable' fair value and a 'reliably measured' fair value.

(c) Please refer to comments in (a). In addition, where local GAAP currently adopts a prospective measurement basis, which considers future cash flows for liabilities under contracts issued by insurance companies, these companies may encounter practical difficulties in obtaining the historic data necessary to apply amortised cost methodologies.

(3) *Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value 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?*

We do not think that any further limitations on the option would be appropriate.

(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 agree with the Board that, for the reasons given in paragraph BC6(a), the fair value option should be available for financial assets and liabilities that contain one or more embedded derivatives even if there is no requirement for the embedded derivatives to be separated.

(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 through profit or loss but is not 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 costs 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 raft be applied retrospectively by restating the comparative financial statements?*

We agree with the IASB's proposed transitional requirements.

(6) Do you have any other comments on the proposals?

Our understanding is that many insurance companies that will be first-time adopters of IFRS in 2005 will opt to apply IAS 32 and IAS 39 in their 2004 comparative figures. This contradicts the IASB's anecdotal evidence referred to in BC28(a). Insurance companies are likely to opt to apply IAS 32 and 39 in the 2004 figures to avoid significant presentational differences between the figures presented for 2005 and those presented for 2004 (for example in relation to adopting deposit accounting for contracts that will be treated as financial liabilities under IAS 39). For companies planning to apply IAS 32 and 39 in their 2004 comparatives, on-going uncertainty over the requirements of IAS 39 are causing significant practical difficulties for implementation projects.

Ref T/701/004A
21 July 2004

[N011705A*FRT/DWRI/DERYCK/2004]