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Fortis Position Regarding Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option

Following to your invitation to comment on the above Exposure Draft, Fortis has carefully examined the proposed amendments to the Fair Value Option in IAS 39. Our comments are included below.

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

Fortis strongly believes that the use of the fair value option should not be further restricted. The fair value option enables financial institutions to apply a consistent accounting treatment to economically hedged positions. It helps resolving some of the issues that arise, for both banks and insurance companies, from the mixed measurement of financial assets, financial liabilities and derivatives and from the restrictions placed on hedge accounting. Additional restrictions, such as the requirement to demonstrate that a substantial offset with another position exists, is contrary to the intention to preserve the fair value option as a less restrictive alternative to hedge accounting.

Similarly, the requirement for a contractual link between assets and liabilities will create additional difficulties for insurance companies who intend to use the fair value option as a solution to the measurement mismatch. Under IFRS 4, insurance liabilities can be measured at fair value (or reasonably close to) in certain circumstances. It is not clear in the proposed amendment whether entities will be allowed to measure financial assets that back such insurance liabilities under all circumstances. In particular, this proposed amendment needs further guidance in the context of IFRS 4.45.

Further, as the ED mentions in its basis for conclusions, fair value measurement is more appropriate for certain activities, such as private equity investments, where there is an established industry practice to measure investments at fair value through P&L and the use of the FV option in such circumstances should not be submitted to additional conditions.

Finally, Fortis is not in favor of introducing the test of verifiability of fair value. This notion creates a hierarchy in the fair valuation requirements that depends on the classification of the financial asset or liability. We believe that this will lead to inconsistencies and practical problems. For example:

- complex embedded derivatives that require separation from the host contract will be fair valued through profit or loss if fair value is reliably measurable, while the measurement of the combined instruments at fair value through P&L will be submitted to the verifiability test;
- for available for sale investments, fair value needs to be reliably measurable, while the fair value of the same investments would be submitted to a stricter test (i.e., verifiability) if they are classified at fair value through P&L.

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?

(a) All loans and receivables and all financial liabilities for which the conditions in the ED are not met will not be eligible for fair value classification. The fair value option should allow to measure at fair value through profit or loss all financial assets, including loans and receivables, in particular when they back insurance liabilities that can be fair valued under IFRS 4.

(b) The verifiability of fair value can be subject to interpretation and it is unclear how this differs from the "reliable measurement" requirement present in the current version of IAS 39. In particular, the concrete impact on structured products with complex embedded derivatives and on unquoted instruments, such as loans, private placements, private equity investments and insurance products is likely to be opposite to the Board's intentions to maintain the FV option for all the situations where its use is justified.

(c) Although the interest rate margin hedge proposal by the EBF/FEB is considered to be a better solution to the macro hedging issue and Fortis is strongly in favor of this proposal, the FV option should remain an alternative to the complex and burdensome macro-hedge accounting requirements.

It is also a solution to the measurement mismatch that both banks and insurance companies will face under IFRS and an alternative to the separation of embedded derivatives.

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?

In Fortis opinion, the concerns mentioned in paragraph BC9 cannot be used to justify restrictions to the FV option.

Firstly, the fair valuation of financial instruments often involves some degree of subjectivity. Considering that this does not eliminate the requirement to measure at fair value through P&L instruments held for trading as well as complex derivatives, the argument that this may inappropriately affect profit or loss in case the fair value option is used is not acceptable.

Secondly, it is very unlikely that companies will use this option to increase volatility. We believe that the importance shareholders, analysts and creditors give to the stability of earnings fully discredits such an assumption.

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?

Fortis is not in favor of limiting the fair value option to financial instruments containing embedded derivatives that require separation. Natural or deliberate hedges of embedded derivatives that do not require separation may exist. The standard should avoid restrictions that are likely to create additional measurement mismatches.

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?

Fortis is concerned with the complexity of the transitional adjustments.

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

Any reference to the regulators should be avoided in the final text. Prudential control and accounting principles should not interfere with each other.

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