



The European Insurance CFO Forum
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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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Dear Sir David,

Response to Exposure Draft: Financial Instruments – Amortised Cost and Impairment

We are taking this opportunity to comment on your exposure draft – Financial Instruments – Amortised Cost and Impairment (the “ED”). This letter has been drafted by the European Insurance CFO Forum, which is a body representing the views of 20 of Europe’s largest insurance companies. Accordingly, it represents the consensus views of a significant element of the European insurance industry.

As insurers, we take a holistic view of the balance sheet, managing and matching assets and liabilities. Accordingly, given the state of flux of the Insurance Contracts Phase II project, and the status of, and relevant impact on, IFRS 9, it is not yet clear which assets we will classify at amortised cost. It is important that this response letter is therefore considered in the context of this uncertainty. In particular, we are concerned that the proposals have been put together from a banking perspective with a portfolio of loans in mind and not a bonds portfolio, corporate or government, which would be more relevant to the insurance industry.

We welcome the release of the Exposure Draft as an important step to improving the impairment model for financial instruments. We support the concept of an expected loss model given the limitations of the existing incurred loss model including the late recognition of losses and the fact that all expected cash flows are not recognised. However, there are significant concerns in relation to the unnecessary complexities of the effective interest rate model proposed and we believe that these proposals will be difficult to apply in practice. We therefore suggest a few practical expedients to the current approach which we refer to below.

The insurance industry is likely to have very different assets at amortised cost compared to banks and it is important that the proposals are appropriate for such assets

As stated above, we are still considering which assets will be classified at amortised cost under the new IFRS 9 proposals and therefore which assets are affected by these proposals. These are likely to include corporate bonds and government bonds, for example, and, furthermore, IFRS 9 does not explicitly disallow the use of amortised cost for tranches of securitised loans so

companies would need to consider whether these assets could meet the amortised cost criteria and then consider what the implications of the proposed amortised cost measurement would be.

Bond portfolios are very different to originated loans held by banks and we are concerned that the impairment model may have been designed with the latter in mind rather than the former. We welcome the consideration of wider asset classes by the EAP as part of their deliberations and would encourage the development of simplified models in such cases.

The expected loss model is conceptually appropriate but the proposals require simplification

We support the high level proposals that an entity should estimate expected losses when the asset is first obtained and welcome the earlier recognition and disclosure of impairment compared with the current incurred loss model. To the extent that one of the objectives is to reduce procyclicality, we believe that a “through the cycle” approach, which uses information over a long period of time, would be the best method to achieve this as the most appropriate reflection of current loss expectation.

We agree with the principle that amortised cost should represent the present value of expected cash flows over the remaining life of the financial instrument. We would however prefer to determine the present value of expected credit losses separately from the contractual interest revenue/expense. We believe that the proposal to recognise subsequent changes in estimates directly in profit and loss is inconsistent with the general objective of the expected loss model which is to recognise the expected loss over the lifetime of the instrument. The impact of the current proposals would be exacerbated for long dated assets such as those held by insurers using the amortised cost category.

We recognise that the application of an expected loss model will still require judgement but consider that it could bring greater transparency and comparability than the current regime and therefore provide more decision useful information to the investor. We support the creation of the Expert Advisory Panel (EAP) to advise on how practical challenges might be addressed and to field test the proposals. As you are aware, two experts from CFO Forum companies have been participating in the EAP. We fully support the consideration of issues around operational matters raised by the EAP as part of the Boards deliberations, particularly with relation to decoupling the initial expected credit losses from the contractual cash flows in the effective interest rate calculation.

However, we have concerns that the proposed effective interest rate approach is unnecessarily complex and would be difficult to apply in practice, detracting from the objective to improve comparability. The ED has confirmed that cash flows should be probability weighted but it is not clear from the current proposals whether a full stochastic model approach is required. Of particular concern is the requirement to consider all future scenarios in the calculation which could result in considerable divergence in practice between companies as well as practical issues.

In terms of the data to be included in the model, we agree that the data may come from various sources (ED B7) and consider the use of historical data with an adjustment for current expectations to be the best approximation for expected values, similar to what banks are currently calculating for loan loss provisions. We reiterate the concerns we expressed in our response to the request for views that the expected loss approach as we currently understand it is likely to present some significant operational issues.

Given the concerns above, we believe that clarification should be provided around the basis for determining cash flows for inclusion. We believe that a clarification similar to paragraph B4 of appendix B to the IAS 37 measurement of liabilities ED would be appropriate which sets out that

calculating the probability weighted average for all possible scenarios is not always required. We will also be interested in the conclusions on how the application of the guidance on a portfolio rather than individual basis would work in practice.

We have not set out the details of an alternative model at this stage as we believe that the focus should be on getting the principles right and simplifying the approach.

The valuation model should be entity-specific rather than referenced directly to the market

As stated in our response to the request for views in September, we believe that the proposals should include more explicit guidance for the estimation of expected future cash flows, particularly on how to determine expected default rate assumptions. While IAS 39 considers market observable information to be more reliable than that which is internally generated, we believe that expected loss estimates should be determined by the entity based on historic data for similar assets of the same terms (including internal or external information such as rating agencies data). We do not believe that a requirement to use market participant data would be either feasible or increase the accuracy of loss estimates. Accordingly, we believe that market value should be limited to use as an indicator of a potential restriction of cash flows and the model should be entity-specific rather than referenced directly to the market. Market references should be for guidance only as a relevant input but we believe entities are best placed to determine cash flows based on their own knowledge.

The objective of the exposure draft is to define the basis of calculation of amortised cost as distinct from fair value. In that context we would contend that value is not as important in an amortised cost scenario as the question of whether cash flows will be received or not. It is important that the definition of amortised cost proposed in the exposure draft is not essentially fair value by another name.

We support a principles based approach supported by non-mandatory guidance and appropriate disclosure

We believe that the standard itself should be short and limited to high level principles allowing the application of judgement not prescriptive rules based guidance. Non-mandatory guidance could be provided as a separate document which can be updated as best practice is developed similar to the guidance provided by the FV EAP in October 2008 in relation to the fair value of financial instruments in markets that are no longer active. We support appropriate disclosures and believe that these can be used to explain to the user the rationale and judgement used in applying the high level principles.

If you have any queries or questions that you would like to raise in relation to the matters raised in this letter, please feel free to contact me.

Yours sincerely



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Chairman – European Insurance CFO Forum