CFO FORUM

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: Fair Value Option for Financial Liabilities

We are taking this opportunity to comment on your exposure draft – Fair Value Option for Financial Liabilities (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.

We support the retention of IAS 39 requirements for financial liabilities and the fair value option

We support the IASB’s decision to retain the existing classification and measurement requirements in IAS 39 for financial liabilities including the ability to use the fair value option (“FVO”). We understand the rationale behind the changes to the FVO to address the treatment of changes in the liabilities’ credit risk and agree that it may be appropriate in certain circumstances to reflect the credit risk in valuation of financial liabilities.

Current proposals potentially create a mismatch where liabilities designated under the fair value option are managed with financial assets measured at fair value through profit and loss

As insurers, managing and matching assets and liabilities on the balance sheet is a fundamental part of our business model. We use the FVO in many cases to avoid a mismatch and we do not believe it is appropriate to include the changes in credit risk in Other Comprehensive Income (“OCI”) where this would create a mismatch for example when the market credit spreads of assets are reflected in profit and loss.

We note that a material mismatch issue may already be avoided for those liabilities with unit-linking features which are in the scope of IFRS 9 as IFRS 7 paragraph 10(a) states that the change in credit risk would be determined as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk. For a unit-linking feature, it specifically states that changes in market conditions include changes in the performance of the related internal or external investment fund.

Therefore, for unit-linked contracts which are in the scope of IFRS 9 and are designated under the FVO, most of the change in fair value would be attributable to market risk as any remaining credit risk component would likely be immaterial. However, the standard should confirm that this principle should also apply where there is asset and liability matching in the absence of unit linkage. In this context, we believe that such a confirmation would achieve a similar result to the alternative view set out in paragraph BC20 of the Basis for Conclusions. For the avoidance of doubt we support the alternative view as it would ensure that no accounting mismatches would be introduced as a consequence of the proposed changes.

We also have concerns that the proposals for changes in credit risk in relation to the fair value option may be misinterpreted as the definition of "credit risk" is unclear

We have concerns that the term "credit risk" could be interpreted differently as it is not clear whether it includes the credit quality of the issuer and the credit quality of the actual liability. The section entitled "Determining the effects of changes in a liability's credit risk" within the invitation to comment section of the ED mentions that the Discussion Paper ("DP") *Credit Risk in Liability Measurement* uses the term "credit risk" broadly to include both the price of credit and the credit quality of the issuer and noted that almost no respondents differentiated these two items. This presumably means that both elements are expected to be included within the calculation in the ED.

We stated in our response to the DP in September 2009 that changes in fair value related to own credit standing should not be reflected in profit and loss and so we would support the proposals to include these in OCI in this respect. However, we do not believe that changes in the fair value related to credit risk of liability should be taken out of profit and loss where a mismatch arises as stated above. We would welcome greater clarity in terms of the definition to avoid confusion and inconsistent interpretation by clearly distinguishing between the credit standing of the company and the credit risk of the liability.

Given the status of the insurance contracts and financial instruments proposals, there is still uncertainty around which liabilities will fall under IFRS 9 and therefore could be designated using the FVO

It is unclear at this stage, due to the current status of the insurance contracts project, which liabilities will fall under IFRS 9 and which of those could be designated using the FVO going forward therefore it is difficult to assess the full implications. In particular, there is still uncertainty around whether investment contracts with discretionary participation features (DPF) will fall under Phase II insurance contracts or IFRS 9 which would cause significant issues if such contracts fell under IFRS 9. Similar complications would also arise if the insurance contracts project were to require "unbundling".

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

Dieter Wemmer
Chairman – European Insurance CFO Forum