The European Insurance CFO Forum
C/- Mr Denis Duverne
AXA
25 Avenue Matignon
75008 Paris
France

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

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Dear Sir David

Fair value accounting issues

This letter is drafted by the European Insurance CFO Forum and is intended to supplement the letter sent to you on 30 October 2008 and the points raised by the CFO Forum at the credit crisis roundtable meeting held in London on 14 November. Initially we wanted to express our disappointment at not having received any feedback from the Board on our previous correspondence. Furthermore, whilst we welcome the various initiatives launched by the Board and the FASB, including the roundtables, we are concerned that such processes might not allow the implementation of timely solutions to some key issues prior to the 2008 year end. Accordingly, this letter is intended to provide some further detail to assist the IASB in their deliberations in this area. We understand that the Board plan to discuss the feedback from the roundtables in their December meeting and therefore wanted to contribute to that debate.

As you are aware we wrote to you on 30 October to reinforce our view on one particular issue in relation to the response to the credit crisis (an issue also raised by the European Commission in their letter of 27 October) that we continue to regard as a priority. We urged the IASB to allow reclassification, at fair value on the date of transfer, from the "fair value through profit and loss" (FVTPL) category to another category for both trading assets **and** assets designated at fair value by option if there is an unequivocal change in business intent to hold the instruments as a result of the lack of market liquidity. Moreover, we stated our view that reclassification of trading assets or assets designated at fair value by option from the FVTPL category to another category should be allowed when there are changes in business model in response to 'hexogen' factors, for instance, when the market conditions no longer permit entities to manage the assets and have the corresponding performance evaluated on a fair value basis or in newly created mismatches situations.

We did not set out in our letter of 30 October the difference between the use of the fair value option and the definition of "trading" under US GAAP as compared to under IFRS, although we did raise this matter at the roundtable in London that we participated in. Accordingly we wanted to take this opportunity to provide some further detail on this issue as we feel that the difference between US GAAP and IFRS in this area undermines the "level playing field" objective pursued by the Board in making the changes to IAS 39 on 13 October.

The fair value option became effective in US GAAP in 2008, significantly later than under IFRS, and the indications are that it is being used much less extensively by insurers reporting under US GAAP than by IFRS reporters. A significant factor in this situation is the fact that the definition of "trading" under US GAAP is significantly wider than that under IFRS. Accordingly, the criteria under which a financial asset can be classified as "trading" under IFRS are much more stringent whereby insurers were generally required to use the FVTPL designation in order to measure assets at fair value and take movements therein through profit or loss. We attach as an appendix to this letter some brief technical analysis to support this distinction.

We understand that the Board have made the decision to bring the financial instruments project onto its active agenda and that there is a long term objective of achieving convergence between IFRS and US GAAP in this area. However, we believe that a short term measure is required to address the lack of consistency which currently allows (in rare circumstances) US GAAP filers to reclassify assets that, whilst meeting the definition of trading for US GAAP, would not do so under IFRS, thus not providing IFRS filers the same opportunity. The ability to reclassify financial assets designated at fair value by option under IFRS under the circumstances set out above, and based on the rationale referred to in our letter of 30 October, would provide such consistency in the short term.

We would again stress that we believe that it is imperative that this proposal is adopted as an immediate solution and that it remains our strong preference for these changes to be enacted by the IASB. Additionally, as explained at the London roundtable meeting we also have concerns over the mixed messages given around the use of mark-to-model valuations, and their interpretation by auditors, as well as over the Available-For-Sale impairment principles and would request that these issues are also addressed urgently by the Board.

We will be happy to discuss further with you, other Board members, or the staff, any matters that are unclear either in this letter or in the appendix.

Yours faithfully

Denis Duverne, Chairman
European Insurance CFO Forum

Cc Gavin Francis, Peter Clark – IASB Staff

Appendix

Technical analysis

The fair value option as such was introduced with an effective date of 2008 under US GAAP with earlier adoption permitted. Before then, US companies could use the Trading designation instead as the US GAAP definition of Trading was (and still is) wider than the IFRS definition of Trading. As a result, insurance companies under US GAAP (including FPIs) used the Trading category more extensively under US GAAP than they did under IFRS. Another reason for the more extensive use of the Trading category by financial institutions including insurance companies under US GAAP is the existence of the Investment Company Guide under US GAAP, as a result of which assets held by consolidated mutual funds were designated as Trading assets with no other choice if held by certain types of funds meeting a certain number of criteria.

Under IFRS, the use of the Trading category is much more restrictive and the fair value option is the only alternative.

As a consequence, there may be circumstances under which reclassifications, although only allowed in rare circumstances under US GAAP, could be permitted for certain types of assets under US GAAP at the end of 2008, while not being allowed for the same assets under IFRS because they were designated under the fair value option, given that the Trading category could not be used for those assets. This creates a significant difference between the two GAAPs. The elimination of differences in definition of the Trading category under both GAAPs is probably a (long term) goal, but **it would not solve the current differences** in possible treatment which can only be aligned by allowing reclassifications out of the fair value option under IFRS under certain criteria. These criteria could be restricted and include, for example, the fact that the conditions prevailing at initial recognition allowing the election of the fair value option are no longer met (measurement of the performance on the basis of fair value, mismatch, - see CFO Forum letter of 30 October).

Relevant literature

US GAAP Trading definition

- FAS 115.12.(emphasis added): *securities that are bought and held **principally** for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading **generally** reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.*

- **Guide to Implementation of FAS 115** (35): *if an enterprise acquires a security without the intent to sell it in the near term, may it classify the security in the trading category? **Yes. Classification of a security as trading is not precluded simply because the enterprise does not intend to sell it in the near future.** The Board **deliberately** used the terms "**generally**" and "**principally**" in describing the trading category. However the decision to classify a security as trading should occur at acquisition; transfers into or from the trading category should be rare.*

The question addressing the possible extension of the use of the Trading category under US GAAP is precisely the one allowing, although only under rare circumstances, the reclassification out of the Trading category highlighting in doing so the absence of contradiction between the optionality of the designation at inception and the subsequent possible reclassification. The absence of difference between the Trading category and the new Fair value option under US GAAP can also be demonstrated by the language used in FAS

159, e.g. *15* (emphasis added). *For available-for sale and held-to-maturity securities accounted for under Statement 115 for which the fair value option has been elected upon the initial adoption of this Statement (**thereby effectively reclassifying those securities as trading securities**), the amount of the effect of that **reclassification into the trading category** shall be separately disclose…*even though highlighting the need for separate disclosure.

IFRS definition

(Emphasis added)

A financial asset or financial liability is classified as held for Trading if it is:

*i) acquired or incurred principally for the purpose of **selling or repurchasing it in the near term**,*
*ii) part of a portfolio of identified financial instruments that are managed together and for which there is **evidence of a recent actual pattern of short term profit taking**, or*
iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Although IAS 39 also uses 'principally', the interpretation is in practice that the use of the Trading category is more limited under IFRS.