CFO FORUM

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

23 March 2009

Dear Sir David,

We welcome the opportunity to comment on your Exposure Draft – *ED10 Consolidated Financial Statements* (the "Exposure Draft" or "ED10"). 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. The letter represents a consensus view from those companies on issues specifically impacting the European insurance industry. In this regard, we have focused our response primarily on issues arising from management of, and holdings in, investment funds as this represents an important area of an insurer's operations directly affected by the proposals in ED10. However, you should note that the issues raised in this response in relation to investment funds are illustrative of concepts that are more widely applicable.

Executive Summary

The exposure draft reflects the complexity of this subject, accordingly we consider the main focus should be to provide as simplified a definition and assessment of control as is possible. We support the IASB's objective to provide a clear principle to determine control for the purposes of consolidation and agree that clarity is needed to ensure entities are consolidated where appropriate. As significant investors this is an important issue for us.

Equally we do not believe it is appropriate to consolidate entities which we do not control. This issue is of particular importance to us in relation to the treatment of investment funds which we primarily operate to manage policyholder funds in our long term savings business. Treatment of investment funds under IFRS has long been an issue for insurers and we originally wrote to the IASB on this issue on 30 March 2004. The Board's proposals for consolidation as set out in the exposure draft and, in particular, recognition of an agency relationship, provide a good opportunity to address this issue.

We appreciate that the timetable for the consolidation project was accelerated as a consequence of the current financial crisis and concerns about off balance sheet vehicles. However, it is important that the Board gives sufficient consideration to the issues raised in this letter and the dual role that insurers may hold with respect to investment funds.

Most insurance companies have an in-house investment management function but also make use of third party investment managers. In some circumstances an insurer may be an investment manager but have only third party investors in the fund; in other circumstances the insurer may hold an investment in a fund managed by a third party. The situation becomes more complicated when the insurer has a dual role in a fund as investment manager and investor. This is further

complicated to the extent that insurers are primarily investing funds for the benefit of policyholders.

We support the proposed principle that combines the concepts of power to direct activities and the ability to generate a return for the reporting entity. This is a considerable improvement over the current situation where it is not clear in which circumstances SIC 12 overrides IAS 27. However, there are a number of areas where explanation of the intent and revisions to the text are needed to support the single principle of control and ensure it would operate as intended in practice. Areas on which we elaborate further below are as follows:

- The distinction between structured and “normal” entities
- Variability and significance of returns
- Policyholder funds
- Continuous assessment
- Purpose and design
- Related arrangements
- Dual role and the agency relationship
- Fees
- Removal rights.

In relation to disclosure we believe it is important not to confuse investors by the inclusion of significant additional information that is not decision useful. In our view decision useful information in the context of unconsolidated entities relates to risk exposures associated with assets and liabilities held by the reporting entity. We believe that these disclosures will largely be met by IFRS 7 requirements and hence any additional disclosures introduced by the consolidation standard should aim to complement IFRS 7 and should avoid duplication.

Detailed comments

Objectives of ED10 and the proposed consolidation model compared to current practice
We support the objectives of the Board in developing a standard that provides a single definition of control for all entities. We also support the definition of control as the power to direct activities to generate returns for the reporting entity. We believe that the Board’s approach in ED 10 that proposes that the controlling entity model should be the only basis for consolidation is an important step forward in this area. We believe that having a single criterion for consolidation that applies to all entities will clarify the current consolidation principles that exist in IAS 27 and SIC12 under which application issues have created diversity of approach in practice. [*Questions 1, 2 and 8 to the exposure draft]*

Concerns around application of SIC 12
We have some significant concerns with the current application of SIC 12, which, in our view, provides an alternative rules-based “bright line” risks and rewards model that is interpreted as overriding the principles of control in IAS 27. We support the view that principles should be given priority over rules and hence a “bright line” approach avoided (as clearly articulated in BC113). Under current practice, we consider that the risks and rewards model that leads to consolidation of entities when the reporting entity obtains the majority of its returns, even in the absence of power to direct the activities, is not consistent with the principle that assets and liabilities of an entity should only be recognised in the consolidated balance sheet to the extent that the reporting entity has control of them. In summary, SIC 12 very often results in a mechanistic approach, for example to the consolidation of investment funds without the existence of a control relationship.

Investment in funds – an example fact pattern and analysis
In order to assist the Board in understanding the specific nature of the activity of investment in funds (including OEICs, mutual funds etc) by insurance companies we can set out a typical

simplified fact pattern and consider this situation in terms of both current practice and under the ED10 proposals:

An investment manager, a wholly owned subsidiary of an insurance company, sets up a fund for investors, under strict regulatory supervision. Investors could be policyholders of the insurer, the insurance company itself or third parties. The investment policies of that fund, fee structure and other operational rules will be set out in the investment mandate and the fund constitution. Regulation prevents any variance from the pre-set approach to these aspects and the fiduciary duties imposed on the investment manager by law require it to act in the best interests of all investors equally. The insurance company can invest policyholders' monies by buying units or shares in the fund.

Under SIC 12 a holding by the insurer of greater than 50% of the units or shares would generally be considered to require consolidation of the fund as the insurer would be deemed to gain the majority of the risks and rewards. The entire assets (and liabilities) of the fund will be included in the insurance company's consolidated financial statements with a financial liability recognised for the share of the net assets held by external investors.

The insurer cannot use the assets of the fund for its own activities and must act in the best interests of all investors equally. The insurer is only at risk in respect of the shares it owns, which are already reflected on the balance sheet, and is not entitled to any return in respect of the shares held by a third party, other than a normal investment management fee. Given the pre-determined nature of the fund's investment options and operations the insurer does not have the power to direct activities in order to achieve a return for itself, and hence our analysis of ED 10 is that consolidation should not be required. Economically, it would not be relevant to consolidate the fund to the extent the insurer does not control the underlying assets of the fund; the financial statements of the insurer should only reflect the investment held in the fund; any present obligation should also be recognised. Under IFRS 7 risk disclosures associated with the investments held by the insurer will be provided. We believe that, by reflecting this economic position, the financial statements would provide better decision useful information for investors.

Based on this interpretation of ED10 and in contrast to current practice, funds in which an insurer obtains more than 50% of the returns would no longer be consolidated to the extent the insurer can evidence that it has no power to direct the activities of the fund. The agency relationship concept discussed below is important in this analysis. It should be noted that any asset or liability held in an unconsolidated entity would be recognised in accordance with IFRS recognition and measurement principles. Furthermore, any commitments arising are disclosed by the reporting entity.

In circumstances where the investment manager is operating the fund as an agent, and does not have the power to direct activities in order to generate a return other than in its capacity as an agent, the percentage holding of the insurer is irrelevant in terms of how the fund is managed and hence whether there is control over that fund. The percentage holding is a risks and rewards indicator and has no effect on the assessment of power.

It is worth noting that an insurer is only entitled to returns (positive or negative) in respect of its share of the fund thus limiting its loss to its investment. This is not necessarily the case in a parent / subsidiary relationship.

By extension of the above argument, it may not be relevant to use the equity method of accounting for funds in which the insurer obtains more than 20% of the returns to the extent that the insurer has no significant influence. In practice, and by analogy to the SIC 12 interpretation, these funds are currently often accounted for under the equity method despite such a lack of significant influence.

Furthermore, in response to question 12, we support retention of the equity method and reconsideration of the IAS 28 principle for determining significant influence in conjunction with that proposed by ED 10.

Specific comments on control assessment model proposals

As indicated above, we support the objectives of the exposure draft and the proposed model; however, we do have concerns that there are some potentially significant inadvertent consequences in applying some of the proposals as set out in ED 10. *[Question 3]* Some aspects of the exposure draft (in particular paragraphs 27, 28, 33 and B11) could be interpreted in a way that might be directly opposite to the intention of the control model, possibly leading to an inadvertent increase in the scope of funds requiring consolidation. As indicated above, such a situation could result in grossed up balance sheets with a resulting lack of focus on the relevant aspects of the financial statements, in addition to significant practical issues around reporting and data collection. The consolidated balance sheet would mix the share of assets belonging to third parties (on which the reporting entity has no risk) with the share of assets belonging to the reporting entity.

One general solution to minimise the scope for misinterpretation would be the provision of greater clarity over the objectives of the standard and around specific aspects of the proposals to ensure they align with those objectives. Such clarity will ensure that substance over form arguments can be supported by reference to the standard. For example, if, as we understand, there is no implicit requirement that all entities should be consolidated by another entity, then this should be explicitly stated in the final standard for avoidance of doubt. More specifically, there are a number of particular aspects of the exposure draft that we believe would benefit from amendment or clarification and these are discussed below.

The distinction between structured and "normal" entities [Questions 6 and 7]

The distinction between "structured" and "normal" entities when assessing control is confusing given the objective of providing a single model based on power and return. By introducing this distinction and dealing with the two types of entity in the way the exposure draft does, there is a danger that the SIC12 risk and reward model could be retained in assessing control of structured entities.

Whilst paragraphs 23-29 deal with "normal" entities with voting rights or other arrangements, paragraphs 30-38 deal with structured entities. The latter include specific references to returns and hence a wider consideration of "control" rather than merely representing an assessment of "power" as is the case for "normal" entities. We understand that this approach has been adopted as the need to consider returns for structured entities is considered an integral part of the control assessment and therefore should not be looked at separately to power. We agree that an assessment of control should include consideration of returns. However, as described in paragraphs 19 and 20, it should be a separate assessment, even if linked, to the assessment of power. We believe that directly introducing the assessment of returns among the criteria of power described in paragraph 31 (b), and by discussing returns further in paragraph 33, could lead to confusion that, for structured entities, the significance of returns is sufficient evidence of power. This could result in conclusions that are not in accordance with the underlying control model and would lead to inconsistencies in the application of this model between "normal" and structured entities. We concur with the view expressed in BC 119; structured entities should not be treated differently from other entities when applying the definition of control. BC 109 also states that whether a reporting entity concludes that an entity in which it has an interest is a structured entity should not affect the control assessment and thus, consolidation.

We would support the removal of the structured entities distinction in assessing control and would expect the consequent changes to remove paragraph 31(b).

Variability and significance of returns
We believe that references in the exposure draft to the concept of variability of returns, and in particular paragraph 33, are potentially confusing and open to mis-interpretation. For example, we believe that there is scope for confusion over the requirement to consider absolute returns (paragraphs 4, 19 and 20) as against exposure to the variability of returns (paragraph 13). Furthermore, if the returns generated are not significant, we do not believe that it should be concluded that control exists. However, paragraph 4 could suggest that whatever the level of returns, even if they are not significant, a reporting entity controls another entity if it has the power to direct its activities. In order to avoid any unintended consolidation, we believe that paragraph 4 should add that the returns must be significant.

In relation to paragraph 33, we agree with the first sentence of the paragraph that indicates that, generally, the more a reporting entity is exposed to the variability of returns from its involvement with an entity, the more power the reporting entity is likely to have to direct the activities of that entity that cause the returns to vary. However, the point expressed is similar to paragraph 13 that should apply to any type of entity, including structured entities, and hence we would question the need to repeat it.

We believe that the second sentence of paragraph 33 ("a reporting entity is likely to have power to direct the activities of a structured entity if it is exposed to the variability of returns that are potentially significant to the structured entity and the reporting entity's exposure is more than that of any other party") could have potential consolidation implications that would not be relevant and could be contrary to the control model developed in ED 10. The words might suggest a rule based approach and it could be interpreted as similar to a "fall back test" with a control threshold that could be in practice be even lower than the *majority* of risks and rewards criteria applied by SIC 12. Accordingly, this could suggest that any holdings in a fund (for example, one of 25%) that exceed those of other investors would require consolidation of the fund, even if it would not be relevant to the extent the reporting entity has no power over the underlying assets of the fund. Our understanding is that it would still be necessary to evidence that there is power to direct the activities in addition to being exposed to the returns and this is consistent with various references throughout the Basis for Conclusions. Hence, the second sentence of paragraph 33 does not appear to be consistent with the Board's views and is open to mis-interpretation. By analogy, it should be clarified that paragraphs 27 and 28 do not require consolidation as a result of a larger relative holding compared to other parties in the absence of power.

We strongly recommend that paragraph 33 is deleted from the final standard.

Policyholder funds
We believe that the final standard should take into consideration situations where returns received by a reporting entity from a structured entity are wholly, or almost wholly, legally and/or contractually due to third parties rather than to the reporting entity itself. This type of situation is particularly relevant for insurance companies where investments are made on behalf of policyholders, for example in unit-linked or with profits funds. In the case of a unit linked fund, the policyholder benefits (and suffers negatively) 100% from the performance of the underlying assets. Given the definition of control refers to the need to "generate returns *for the reporting entity*" it would appear to be appropriate to address situations where returns are passed on to other parties for the sake of clarity in the final standard. We would be happy to discuss this specific insurance issue further with you if necessary.

Continuous assessment
We have noted the requirement to assess control continuously in paragraphs 15 and 16 (and as referred to in the Basis for Conclusions) and we support the underlying concept that fluctuations in returns without a change in power to direct activities should not cause changes in control. We believe that this concept supports the views we have expressed above around the need to avoid undue consideration of returns over power.

The application of a consistent principles based approach, as advocated in this letter, would avoid the problems associated with the mechanistic approach to consolidation / deconsolidation which could be construed from paragraphs 28 and 33 in combination with continuous assessment.

Purpose and design
Paragraph 31 states that when assessing control of a structured entity, a reporting entity shall consider all relevant facts and circumstances, including the purpose and design of the entity. Paragraph 32 includes an example where a reporting entity is likely to control a structured entity because of its specific purpose and design. By contrast, we believe that it would be useful to also include in paragraph 32 the example of an investment fund for which the purpose and design may equally be an indicator of lack of control. This would be the case when the purpose of the investment fund is to pool investor's funds to provide them with the advantages of professional investment management and diversification of ownership in the securities markets, the risks of the different parties being strictly limited to the value of their investment that is already reflected on the face of their balance sheet.

Related arrangements
Paragraph 17 states that a reporting entity shall consider related arrangements when assessing control. In this regard an insurer's contract with policyholders should be regarded as a related arrangement that should be taken into consideration when assessing control of an investment vehicle. We believe that it would be useful to include such a situation as an example of such an arrangement in paragraph 18.

Dual role and the agency relationship [Question 5]
The typical insurer/investment management fact pattern set out above illustrates the dual role situation that is of particular relevance to insurers. As indicated above, we believe that there is no apparent intention of the IASB to require consolidation in cases where law, fiduciary responsibilities or investment mandates require the investment manager to act in the best interests of all investors. Hence we fully support the inclusion of the agency relationship concept in the exposure draft which we believe provides a useful distinction of the nature of "power" in the assessment of control. The concept underlies the reason why a reporting entity can have some power over another entity without that power being used to generate returns for the reporting entity itself. Without explicit reference to the agency relationship there would be a danger that an investment manager's power might be mis-interpreted potentially leading to an inappropriate assessment of control.

The final standard could provide greater clarity over the indicators of the characteristics of acting as an agent, including standard investment management situations governed by law, contractual agreement and regulation. A further indicator could be the correlation of the fees between the remuneration of the investment manager and the returns received by the investors as evidence that the investment manager acts in the best interests of all investors. We believe that these indicators should go further than merely being able to demonstrate the presence of a Chinese wall as suggested by the reference to implementing policies and procedures to ensure independence of decision-making in paragraph B11.

In a dual role situation, the concept of "acting in the best interests of other parties" should be clarified. To the extent the different parties, including the reporting entity, have common and convergent interests, the condition is met; when there is a conflict of interest, there should be evidence that all investors are treated equally and that the agent cannot favour the interest of the reporting entity as investor.

When, on the basis indicated above, the agent has to act in the best interests of the principals (being any investors, whatever their level of investment), our interpretation of B11 is that the agent's power (by extension of the meaning of voting rights) should be excluded in the assessment of control of an investment fund. In this case, when a reporting entity has a dual role (as both investor and agent), it should not take into account its role as an agent in the assessment of control. In addition, we believe that B11 should be extended to reflect situations beyond voting rights as it is equally relevant that power of an investment manager should not be considered in a non-voting fund.

In order to clarify this interpretation in the final standard we believe that paragraph 31 should specify that, when assessing control of a structured entity (notwithstanding comments above about the distinction between normal and structured entities), B11 should also be considered. This amendment would appear to be consistent with the objectives of BC 91- 95 regarding agency arrangements.

Our interpretation of B11, when an investor in a fund, whatever the level of its investment, has no unconditional right to remove the investment manager (see below), no ability to change the restrictions or predetermined strategic policies of a fund, and, more broadly, no other way, as an investor (but excluding its power as asset manager acting in the best interests of investors), to direct or influence the activities, he cannot have control over the fund or significant influence on it.

Should the agency relationship concept and the specific allowances in B11 be removed from, or significantly amended for, the final standard or should different interpretations be placed on these aspects, we believe that there may be an inadvertent significant increase in the number of funds requiring consolidation. Even very small holdings coupled with an investment management role might be interpreted as requiring consolidation. Such a situation would increase the consolidation workload and lead to less transparency on consolidated balance sheets as indicated above. We would strongly encourage the Board to ensure that the principles of the agency relationship and paragraph B11 remain in the final standard.

Fees
It should be made clear that fees received as an agent should not be taken into consideration when assessing returns. Even if implied in paragraphs B5 to B8, the future standard should clarify, such as specified in BC90, that an agent will fail the control test except if fees are not commensurate with the services performed.

Removal rights
In order to be relevant in an assessment of control removal rights must be substantive and we believe this should be stated in the final standard. Thus paragraph B4 should clarify that an investor having an unconditional right to remove an agent has the power to direct the activities of an entity only if this unconditional right has substance. The Board's intentions as to the definition of "unconditional" should also be made clear. In an investment fund situation investors will typically divest their funds from that particular investment vehicle rather than take advantage of the clause that allows them to vote out the investment manager. Thus, in the majority of cases, such removal rights will not have any economic substance. Removal rights should be clearly stated as being only an indicator of control and it should be clear that the presence of removal rights does not, of itself, indicate control without further assessment of the facts and circumstances.

Disclosures *[Questions 9 and 10]*
We support the overall objectives of the ED 10 disclosures and in particular the provision of information on risks associated with the reporting entity's involvement with structured entities that the reporting entity does not control.

However, we are concerned that the proposed disclosures are likely to result in the provision of significant detail that is not decision-useful for investors and is practically difficult to derive. On the basis that our interpretations of ED10 around assessment of control of investment funds set out above are correct, then insurers will be in a position where they have "involvement" with significant numbers of unconsolidated structured entities. We do not believe that the IASB intended significantly more lengthy and onerous disclosures in such cases. We believe that information should only be provided if it is relevant for users to assess risk exposure and we would note that, given that the majority of assets and liabilities under consideration will be financial assets or financial liabilities, then there is likely to be a significant duplication with IFRS 7.

Given the potential for excessive non-decision-useful disclosures we would suggest that paragraph B31 should clarify that the disclosures are to be provided only if they present an assessment of the risks to which the reporting entity is exposed. In the absence of risk, or if the disclosure required by the exposure draft is not relevant with regard to the specificity of the risk, the information could be misleading or not useful, leading to burdensome financial statements. For example, in some cases, the information required in B 41(a) related to the income from the reporting entity's involvement with structured entities (i.e. investment management fees in an insurers' situation with regard to mutual funds) is of no relevance to the assessment of the risk associated with this involvement.

We support the proposal in the exposure draft that reputational risk is not an appropriate basis for consolidation and we believe that the disclosure requirement in B47 around reputational risk is useful information *[Question 11]*. However, as it relates to support that has been provided during the period and to the extent it is significant, we anticipate that detailed similar information should already be disclosed under other current IFRS's. Furthermore, we have a concern that it is not clear whether information required to be disclosed under paragraphs B38-B46 should be provided when there is no contractual or constructive involvement, merely reputational risk. In our situation this might include investment managers, sponsors and cases where a reporting entity has established a fund. We have a particular concern that complying with the requirements of paragraph B 46(e) (iii) may have legal implications and/or could establish a constructive obligation.

We do not believe that the exposure draft provides enough clarity as to why the disclosures required by B38-B46 are specifically required for involvements in unconsolidated structured entities and not for involvements in other unconsolidated entities. Furthermore, as, for disclosure purposes, the distinction between these two categories of entities is essential; the future standard should provide enough guidance to allow classification of an entity without ambiguity.

There is considerable scope for duplication of disclosure of similar information in several areas. For example, the carrying value of assets held in structured entities required by B44 (a) may be similar to the exposure to loss required by B44 (d). Similar data may also be provided in other parts of the disclosures (for example, disclosures on investments or commitments). We understand the desire to provide a global view of a reporting entity's exposure to risks in structured entities; however the Board should clarify how to articulate it with the information already presented in other disclosures when required by other standards. Otherwise, if the same data is disclosed several times, there is a risk of misunderstanding for the reader and confusion around the provision of an overall picture of the totality of risks facing the reporting entity.

As indicated above, we believe that IFRS 7 has a particular role around disclosures of risk exposures for financial instruments and additional disclosure requirements introduced by the final

consolidation standard should be developed to complement those disclosures rather than duplicate or replace them.

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. In particular, we would be more than willing to assist you in understanding some of the issues raised herein, for example, through provision of worked examples.

Yours sincerely,

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