CFO FORUM

The European Insurance CFO Forum
C/O Philip G Scott
Aviva
St. Helen's 1 Undershaft
London EC3P 3DQ
ENGLAND

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

1 September 2009

Dear Sir David,

We are taking this opportunity to comment on your Discussion Paper 2009/2: Credit Risk in Liability Measurement (the "DP") dealing with the arguments for and against incorporating credit risk in liability measurement. We understand that the Board has addressed credit risk as part of its Fair Value Measurement project in Exposure Draft 2009/5 and we will refer to this letter in our response to that Exposure Draft. However, we note that this DP covers all instances of credit risk in liability measurement, including those where fair value is not the measurement attribute.

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.

Reflection of credit risk or not should depend on the measurement approach adopted for specific liabilities

In our response to the IASB's Fair Value Measurement discussion paper in April 2007 we stated "We recognise that it is common for financial instruments to price credit risk into their fair value and note that it is often deemed appropriate, within current accounting guidance, to adjust the value of an asset to reflect the risk of non-performance. That said, we believe the consideration of credit risk in regards to liabilities can often lead to counter intuitive accounting. As an industry we believe it would be wholly inappropriate to recognise within our income statement amounts that have arisen due to the fact that the credit standing of our business has changed. From our perspective this would be a misleading representation of the profitability and financial position of our business."

We continue to support this viewpoint but we do recognise that there will be some cases where reflection of credit risk in liability valuation may be appropriate.

Accordingly, we therefore advocate an approach which allows for the inclusion of credit risk depending on the measurement attribute of the liability in question.

Measurement of insurance contracts should *not* reflect own credit risk
We continue to believe that own credit risk should not be considered in the valuation of insurance liabilities.

As you are aware there continues to be significant debate around the most appropriate basis of valuation of insurance contracts. It does appear likely, however, that such contracts will not be measured at “fair value”, as will be defined in the Fair Value Measurement standard, but at an alternative entity specific current value. No active market exists for insurance contracts and hence they cannot be calibrated to market values. Accordingly, a “mark to model” approach exists and, in our view, it would be inappropriate to reflect own credit risk in this model valuation. In addition to the counter-intuitive performance metrics referred to above we would note that insurance liabilities exist in a highly regulated environment which require payment to policyholders before other creditors. It would be inappropriate to value such liabilities at an amount lower than that expected to be paid in fulfillment of the insurers’ obligation to the policyholder. We wrote to Peter Clark on 25 July 2008 supporting a measurement basis for insurance contracts based on a “Market consistent fulfillment cost”. We believe that such a valuation basis should not take own credit risk into account. We support valuation of insurance liabilities using a risk free discount rate which reflects the characteristics of the liability (which should include allowance for a liquidity premium if appropriate).

Measurement of other liabilities *may* include own credit risk
Conceptually, we do not disagree with the inclusion of credit risk where liabilities are measured at fair value but we do not believe that a single approach can be applied to all such liabilities. For example, from a practical point of view it may be appropriate to distinguish liabilities measured at fair value between those categorised at different levels of the fair value hierarchy. Accordingly, one would expect to reflect credit risk in the measurement of those at level 1 whereas this would not be the case for those at level 3 in the hierarchy. It would be practically difficult to *exclude* credit risk from a fair value determined higher up the hierarchy whereas a “mark to model” level 3 valuation would potentially experience the same difficulties *including* the credit risk element.

Certain liabilities, like subordinated notes and loans and borrowings, which are used to finance core structural capital, are managed on a contractual yield basis and are not actively traded and it follows that they should be measured at amortised cost thereby credit risk considerations are not relevant after initial recognition.

We would note that even an insolvent company is liable to pay the nominal value of its debt and it therefore follows that only the creditor should evaluate the risk of receiving repayment. In addition, the assets backing these liabilities are not usually measured at fair value. Adjusting the value of a liability for a decline in an entity’s credit quality and not adopting a corresponding treatment for the impacted assets may result in an accounting mismatch.

Other liabilities have different characteristics and in some of these cases it would be appropriate to reflect credit risk. An example of this might be a securitisation vehicle where the holders of the notes will earn a return based on the performance of the

underlying assets in the portfolio, including the effect of their credit risk. Reflecting this liability at fair value will also avoid any accounting mismatch.

Credit risk of the entity or credit risk of the liability?

We would also note that it is unclear whether the DP is referring to credit risk associated with an entity as whole or whether it is referring to credit risk associated with the specific liability. Paragraph 4 of the DP indicates that it only covers own entity credit risk and the arguments against including credit risk seem to confirm this. However, paragraphs 43 and 44 in the Staff Paper accompanying the DP indicate there is more to the credit risk of a liability than only own entity credit risk since the value of the liability changes due to "all credit-related changes in the value of the liability" even though neither the risk-free rate nor the entity's credit risk has changed. In our view the issues under consideration should be limited to the credit risk of the liability rather than referring to the wider entity's credit standing.

Prescribing the reflection of credit risk in liability measurement is likely to confuse investors

In summary, we do not believe that establishing a single rule for inclusion of credit risk in liability measurement, either on initial measurement or subsequently, is practical and, more significantly, will provide more decision-useful information in financial statements. Reflecting credit standing in liability valuation may result in an accounting profit in the event of a credit downgrade and we consider this to be misleading and possibly masking deterioration in an entity's financial position and solvency. We see informational advantages to investors and analysts in presenting liabilities as credit risk free in many instances. However, we equally acknowledge that there may be some circumstances where credit risk should be reflected in liability valuation, notably where this is supported by the characteristics of the liability (for example, if it is capable of being matched by assets whose value implicitly includes credit risk or is a level 1 fair value measurement).

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,

Philip G Scott
Chairman – European Insurance CFO Forum