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Sir David Tweedie
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Dear Sir David,

Exposure draft ED/2009/7 – Financial Instruments: Classification and Measurement

We are taking this opportunity to comment on your exposure draft, Financial Instruments: Classification and Measurement. 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. As significant holders of financial instruments, notably as long term investors, insurance companies consider this to be a very significant project for our industry. Previous debate in this area has centered on other financial institutions, notably banks, and we believe that it is important that the views of insurers are prominent in the ongoing development of this accounting standard.

This letter has been prepared in the context of the insurance business model which is underpinned by the management of corresponding assets and liabilities and hence the measurement basis for one side of the balance sheet should have full regard to that of the other. We believe that it is important, in order to provide transparent information to financial statement users, that this underlying business model is fully considered in the development of financial instruments accounting.

We welcome and support the IASB's work to simplify this complex area. We support the direction of the IASB's project, notably the recognition that the **business model** should play an important role in classification and the development of a **mixed attribute model** which includes both fair value and amortised cost. We believe that amortised cost is an important category that provides decision-useful information to users in a number of areas, for example for own debt or loans to policyholders. Moreover, amortised cost for our investments creates consistency with our insurance liabilities which are often currently accounted for at amortised cost. On the other hand fair value is appropriate in other circumstances, for example for derivatives and instruments held for trading. More generally, classification should reflect the business model under which assets and liabilities are managed.

A fundamental aspect of insurers' business models is asset/liability matching and therefore the measurement basis for insurance contracts must be developed concurrently with the proposals for financial instruments

Insurers manage and match both sides of the balance sheet and it is important that development of accounting on each side is carried out with full regard to the other. Asset portfolios are acquired by insurers to match liabilities associated with insurance products sold to policyholders (or, in the case of reinsurers, other insurance companies). Accordingly, we believe that accounting for financial instruments and insurance contracts must be developed concurrently, and without delay.

To clarify this point further, we believe that a fundamental principle of accounting is that accounts should reflect how business is managed, reflecting the associated risks undertaken. As insurers, this means that the basis on which we manage our asset portfolios in the context of the valuation and time horizon of our liabilities should be reflected in the measurement and classification of those assets.

As you are aware the longer term basis of measurement of insurance liabilities remains uncertain given the ongoing Phase II insurance contracts project where an exposure draft is anticipated in December 2009. Accordingly, for the reasons set out above, we do not believe that it is possible for us, as insurers, to fully assess the implications of the proposals for financial instruments on insurers until Phase II proposals are clearer. We would stress that this view is not intended to suggest that urgent action is not required with regard to accounting for financial instruments and insurance contracts (please also see our comments on page 5 below in this regard).

We have some concerns around certain specific aspects of the proposals in the ED and the IASB's approach to this project as set out below.

The criteria requiring use of amortised cost is open to interpretation and too restrictive and it would be preferable to replace them with a business model approach

We are concerned that the "managed on a contractual yield basis" and "basic loan features" criteria will not work in practice. In particular, the criteria as drafted may limit instruments that can be categorised at amortised cost, either by design or interpretation, or require instruments currently designated at fair value under the fair value option to be measured at amortised cost.

In respect of the former, paragraph B13 excludes financial assets acquired at a discount that reflects incurred credit losses from the contractual yield criteria. This appears to suggest that, for example, many purchased high yield bonds where incurred credit losses exist, or acquired distressed portfolios, would need to be carried at fair value. We do not believe that such a restriction is appropriate.

Further limitations on the cost category that are considered inappropriate are likely to exist around assets with no maturity such as perpetual debts and other instruments such as term deposits with early repayment features triggered by death. It will be necessary to clarify treatment of such instruments.

The IASB's proposals around "waterfall" arrangements whereby only the most senior tranche of debt can be categorised at cost are also considered inappropriate. We believe that it should be possible to categorise all non-hybrid debt instruments without significant leverage as amortised cost unless they are held for trading or managed on a fair value basis.

If the “basic loan features” and “managed on a contractual yield basis” concepts are to be retained then we believe that principles should be better developed around their definition rather than establishing “bright lines” such as those in the areas set out above.

Insurers have utilised the existing IAS 39 fair value option (“FVO”) in situations where there is no accounting mismatch and it is important that similar use of fair value as an option is retained in the new standard. The ED proposals may be interpreted as requiring financial assets to be categorised as amortised cost given that they are managed on a contractual yield basis despite the overriding investment strategy being one of fair value. In such cases the FVO may be deemed not to be available as there is no accounting mismatch. We have identified such situations relating to debt securities backing term-certain annuity books, held as surplus assets (i.e. not matching any liabilities), and held to cover general insurance liabilities. We do not believe that the IASB intended to restrict the ability to use the FVO further than current IAS 39 allows and would suggest that the final standard is revised to avoid any potentially inappropriate interpretations of the proposals.

We believe that a higher level revision to the classification basis that reflects an entity’s business model rather than applies the “managed on a contractual yield” and “basic loan features” criteria will provide an effective solution to the issues identified above. At the beginning of this letter we indicated that a fundamental principle of accounting is that accounts should reflect how business is managed and we believe that business model criteria for financial instruments provide the most appropriate decision-useful information to investors. The business model, which will differ for particular contracts offered and hence for assets backing those contracts, should be the determining factor in categorising financial instruments for measurement purposes. As indicated earlier we believe that certain financial instruments such as derivatives and instruments held for trading should always be classified as fair value through net income. Others will be classified according to the business model and the decisions made in that regard should be subject to detailed disclosure requirements to ensure full transparency of classification decisions.

Far from forbidding reclassifications we consider that the standard should *require* reclassifications if assets are transferred between portfolios managed according to different business models. This approach would be reflective of a greater emphasis on business model as the determining factor.

It is currently essential to maintain the Available for Sale category to address mismatch issues for insurers

As indicated above, asset/liability matching underlies the insurance business model. In order to mitigate an accounting mismatch, European insurers have made extensive use of the AFS category. This is because under IFRS 4 (“Phase 1”) insurance liabilities are often carried at cost or on a similarly static basis of valuation. Hence, they are valued on a different basis to the corresponding financial assets which must be fair valued as they can not be carried at cost given the onerous tainting rules surrounding the Held to Maturity category. In order to reduce 'accounting' volatility in the income statement, these assets are categorised as AFS thus enabling the corresponding movements to go to equity/OCI. The current proposals in the ED eliminate the AFS category which will increase accounting volatility in the income statement to the extent that these instruments can not be classified in the amortised cost category. This short term volatility is inconsistent with the way we manage investments and distorts the presentation of business performance.

We support the proposal to allow classification of certain debt securities at amortised cost, with the removal of the tainting rules. In particular, this approach will mitigate our accounting mismatch concerns to a certain extent. However, we are concerned that the criteria around the ability to use the amortised cost category are too restrictive (see above). In particular more complex debt instruments and all equities will no longer be able to utilise the AFS treatment which will lead to accounting mismatches. Based on a high level assessment we believe that CFO Forum member companies held approximately 40% of their investment portfolios as AFS in 2008 (equating to over Euro1.5 trillion). Of this amount approximately 10% were equity type investments and 90% debt securities. Based on an initial analysis we would expect at least 10% of the debt securities to not meet the “basic loan features” criteria and hence be unable to use the amortised cost category.

For the reasons set out above we believe that the AFS category, as currently formulated in IAS 39, should be available for insurers prior to the adoption of Phase II insurance contracts accounting. Some of our member companies have indicated that removal of the AFS category, in particular for equity instruments, may result in a change to their investment strategy, which we do not believe to be the IASB’s objective.

As indicated above, there remains considerable uncertainty over the eventual outcome of the Phase II standard and hence the measurement basis for a significant proportion of an insurer’s liabilities. We believe that it will be necessary to reassess our views on the retention of the AFS category in the light of the finalisation of Phase II proposals, including those around accounting for participating contracts.

Financial liabilities also require consideration
It is important that the final standard does not require some financial liabilities to be inappropriately carried at fair value. Most notably this may include an entity’s own debt instruments that do not meet the basic loan criteria, such as convertible debt. It should be noted that a number of investment contracts issued by insurers are held at amortised cost currently and it is important that this practice can continue under the revised standard.

A comprehensive overhaul of IAS 39, ideally on a global basis, is preferable to piecemeal changes
We are supportive of the direction of the IASB’s proposals on classification and measurement and recognise the pressures the IASB is under to address accounting for financial instruments. However, in addition to the specific comments on the proposals set out above, we do not support the piecemeal approach that has been adopted to the project by the Board.

We believe that a comprehensive solution would be significantly preferable to the IASB’s proposed piecemeal approach to replacing IAS 39 and we will need to consider the full set of revised proposals for accounting for financial instruments when completed. We consider that the IASB should have followed an approach similar to that being adopted by the FASB whereby an exposure draft will not be issued until all aspects of the proposals have been further developed. In order to fully understand the overall potential impact of the classification and measurement proposals it is particularly necessary to understand the related impairment accounting proposals that will not be discussed until later in the IASB process. We continue to believe that this is an area requiring urgent attention and we believe that a comprehensive IAS 39 replacement ED, realistically covering at least classification, measurement and impairment, should be released for comment clearly before the end of 2009 (in addition to the insurance contracts ED) with hedge accounting following shortly thereafter. Such an approach would demonstrate consideration of the G20 requirements around urgent action. In particular, we believe that it is important that the IASB addresses the issues in relation to impairment of AFS debt securities that we raised in our letter of 20 April 2009, notably allowing reflection of only credit loss impairments through profit or loss.

We are fully supportive of the development of a single set of converged global standards and ideally we would like to see a single converged financial instruments standard and it would be disappointing if a different outcome was achieved. For the avoidance of doubt, we prefer the direction of the IASB's proposals (subject to the points made in this letter) over those being developed by the FASB.

Mandatory adoption should be aligned with insurance contracts Phase II and/or other transitional arrangements should be made for insurers

Insurers face a prolonged period of change in financial reporting which will further confuse investors. Having converted to IFRS in 2005, further significant change will result from the need to adopt the IAS 39 proposals in, or before, 2012 on the asset side of the balance sheet. In 2013/14 when IFRS Phase II for insurance contracts is likely to be required to be adopted, there will then be further significant changes on the liabilities side. This is in addition to the regulatory reporting changes with the introduction of Solvency II in 2012.

Insurers would therefore like any changes to the corresponding assets and liabilities to be concurrent. Therefore we would either require that a 'sunset clause' is included to enable continuation of the existing AFS treatment until Phase II comes into force or, alternatively, the mandatory application of IAS 39 (Revised) to be delayed until the Phase II adoption date, whilst still allowing voluntary earlier adoption.

Since the outcome of Phase II for insurance contracts is still under discussion it is also very important that insurers have the ability to revisit the classification of financial instruments upon the introduction of Phase II.

Transitional rules should provide an historical cost option with no restatement of comparatives

Under the transitional provisions in the ED, if a financial asset is reclassified to amortised cost (from any fair value category) upon the application of the standard, the asset is valued at the original historical cost. However, this historical cost has to be recorded retrospectively and hence comparatives need to be restated. Whilst we support the requirement of the standard to record the asset at its original historical cost rather than at a deemed cost based on current fair value (since companies would have the historical cost information available), we do not believe that this historical cost should be recorded retrospectively. We are of the opinion that the ED should provide an option to state all relevant financial instruments at historical cost at the beginning of the current financial period with the impact recorded as an adjustment to equity. All changes arising from application of the revised IAS 39 should be treated on a similar basis.

We believe that this approach has a precedent in that it is similar to that used when IAS 39 was adopted by companies during the initial transition in 2005. We believe that this change is of a similar magnitude and hence should follow the same approach.

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

Yours sincerely,

Philip G Scott
Chairman – European Insurance CFO Forum

Appendix

Responses to questions raised by IASB

Question 1
Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

We believe that amortised cost is an appropriate category for inclusion in the new financial instruments standard and should be available for use when an entity's business model supports its application.

We do have some concerns, however, that the criteria established around basic loan features and "managed on a contractual yield basis" are too restrictive. These concerns include the requirement that all tranches of subordinated debt in "waterfall" features below the most senior tranche must be fair valued. We believe that all non-hybrid debt instruments without significant leverage should be able to be categorised at amortised cost unless they are held for trading or managed on a fair value basis. We consider the determination of "significant leverage" to be a matter that should be left to the judgement of entities.

We also have concerns around paragraph B13 which excludes financial assets acquired at a discount that reflects incurred credit losses from the contractual yield criteria. This appears to suggest that, for example, many purchased high yield bonds where incurred credit losses exist, or acquired distressed portfolios, would need to be carried at fair value. We do not believe that such a restriction is appropriate.

Question 2
Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

We do not believe that the ED contains sufficient operational guidance around the criteria for use of amortised cost. In particular, we believe that there is a lack of clarity around the "managed on a contractual yield basis" criteria. Furthermore, there is a lack of clarity around certain instruments including assets with no maturity such as perpetual debts, constant maturity date debt and convertible bonds.

If the "basic loan features" and "managed on a contractual yield basis" concepts are to be retained then we believe that principles should be better developed around their definition rather than establishing "bright lines" such as those in the areas set out in response to question 1..
We believe that a higher level revision to the classification basis that reflects an entity's business model rather than applies the "managed on a contractual yield" and "basic loan features" criteria will provide an effective solution to the issues identified above. At the beginning of this letter we indicated that a fundamental principle of accounting is that accounts should reflect how business is managed and we believe that business model criteria for financial instruments provide the most appropriate decision-useful information to investors. The business model, which will differ for particular contracts offered and hence for assets backing those contracts, should be the determining factor in categorising financial instruments for measurement purposes.

Question 3
Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so, (a) what alternative conditions would you propose? Why are those conditions more appropriate? (b) if additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value? (c) if financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

Yes, we believe that other conditions would be more appropriate.
(a) We would support a model based around an entity's business model - see response to Question 2.

(b) A business model approach would not necessarily extend the scope of the amortised cost category as it will depend on the underlying entity's circumstances.
(c) Again the underlying entity's circumstances will determine the impact. However, we believe that a business model approach will allow certain financial instruments to be classified at fair value whereas the current ED proposals may be interpreted to require their classification at amortised cost and prevent the use of the fair value option where there is no accounting mismatch.

Question 4
(a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts. (b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (ie tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decisionusefulness of information about contractually subordinated interests?

(a) We are still assessing the implications of these proposals for insurers.
(b) No, the proposed approach to contractually subordinated interests is artificial and inappropriate as indicated in our response to question 1 above.

Question 5
Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

Insurers have utilised the existing IAS 39 fair value option ("FVO") in situations where there is no accounting mismatch and it is important that similar use of fair value as an option is retained in the new standard. The ED proposals may be interpreted as requiring financial assets to be categorised as amortised cost given that they are managed on a contractual yield basis despite the overriding investment strategy being one of fair value. In such cases the FVO may be deemed not to be available as there is no accounting mismatch. We have identified such situations relating to debt securities backing term-certain annuity books, held as surplus assets (i.e. not matching any liabilities), and held to cover general insurance liabilities. We do not believe that the IASB intended to restrict the ability to use the FVO further than current IAS 39 allows and would suggest that the final standard is revised to avoid any potentially inappropriate interpretations of the proposals.

Question 6
Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

See our response to question 5.

Question 7
Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

No, reclassification should not be prohibited. Reclassification between categories should not only be allowed, but required, when there are changes in the business model within which the instruments are held.

Furthermore, reclassification should also be allowed for insurers on adoption of the Phase II insurance contracts standard which will change the basis of measurement of a significant proportion of most insurance companies' liabilities.

Reclassifications between categories should be supported by disclosures of the reasons for, and the impact of, the reclassification.

Question 8
Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

We believe that fair value represents the most appropriate basis of measurement for equity instruments in the balance sheet. Please refer to the covering letter for our views on retention of the Available for Sale category.

Question 9
Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

The cost exemption for unquoted securities is not a significant issue for most CFO Forum members although we do not necessarily understand the IASB's logic in this regard (removal of IAS 39 paragraph 46 (c) provision).

Question 10
Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

While we consider that AFS should be maintained and not replaced by the new FV OCI category, in very limited circumstances it may be appropriate to present fair value changes for particular investments in equity instruments in OCI. Please see our comments on the wider use of AFS in the covering letter.

Question 11
Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not, (a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why? (b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

The nature of this category is such that use is expected to be extremely limited and hence we do not believe a principle is required.

Question 12
Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

See our general views on transitional provisions in question 13.

Question 13
Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

Under the transitional provisions in the ED, if a financial asset is reclassified to amortised cost (from any fair value category) upon the application of the standard, the asset is valued at the original historical cost. However, this historical cost has to be recorded retrospectively and hence comparatives need to be restated. Whilst we support the requirement of the standard to record the asset at its original historical cost rather than at a deemed cost based on current fair value (since companies would have the historical cost information available), we do not believe that this historical cost should be recorded retrospectively. We are of the opinion that the ED should provide an option to state all relevant financial instruments at historical cost at the beginning of the current financial period with the impact recorded as an adjustment to equity. All changes arising from application of the revised IAS 39 should be treated on a similar basis.

We believe that this approach has technical merit for the following reasons:

- the changes to IAS 39 are being introduced in stages and it is inefficient and costly (especially given the short lead time and the fact that many companies often provide more than one year of comparative information) to restate comparatives each time revisions to IAS 39 are implemented;
- changes to comparatives, on three occasions over a period of 2 years (each time the revisions to IAS 39 are implemented) would cause significant confusion for users of the financial statements;
- the revised comparative information would not provide meaningful information to users of the financial statements since the business was not necessarily managed on that basis during the comparative period;

- to provide such an exemption, whilst unusual, is not without precedence since a similar approach has been used when IAS 39 was adopted by companies during the initial transition in 2005.

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically: (a) in the statement of financial position? (b) in the statement of comprehensive income? If so, why?

We do not believe that the alternative approach would provide more decision-useful information.

We would also like to take this opportunity to state that we do not support the proposals put forward by the FASB on classification and measurement of financial instruments. As discussed above we believe that amortised cost has an important role to play as a classification for financial instruments in the appropriate circumstances. Accordingly, whilst we support the FASB's principle of retaining an AFS category we do not agree with the omission of a cost category.

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

We do not believe that the variants of the alternative approach would provide more decision-useful information.