

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

Ref: ECO-ACC-09-152

Subject: CEA response to IASB ED on “Financial Instruments – Classification and Measurement”

Brussels, 11 September 2009

Dear Sir David,

The CEA is the European Federation of insurers and reinsurers, who represents all types of insurance and reinsurance undertakings, accounting for approximately 94% of total European premium income. Insurance companies are not only preparers but are also one of the largest institutional investors, hence users of financial statements.

We welcome the opportunity to comment on your Exposure Draft – Financial Instruments: Classification and Measurement. This letter represents a consensus view from insurers on issues specifically impacting the European insurance industry, emphasizing as well the importance of the project being sufficiently open and consistent to cope with the different outcomes of the Phase II of Insurance Contract due to 2013.

General comments

As insurance companies, financial instruments, together with the phase II for insurance contracts is one of the most important projects. It is of utmost importance that the two projects deliver compatible answers. As the timetables of those two projects are not aligned (the insurance contract project is expected to be issued in 2011 while the future standard on classification and measurement is expected to be issued this year), it is important that the latter is sufficiently open to allow compatibility with all possible outcomes of the insurance contract project.

The CEA supports the revision of IAS 39 undertaken by the IASB. Over the past year, we have actively engaged in the various IASB initiatives related to financial instruments (response to consultations, participation to roundtable). However, given the importance of the future standard for insurers, we strongly support that the IASB focuses on delivering the right standard rather than delivering a standard before 2009 yearend. In addition, we believe that the three step approach adopted by the IASB in order to replace IAS 39 (classification and measurement, then impairment and then hedging) increases the complexity of the project. Indeed, as it is quite difficult to take firm positions on classification and measurement when rules for impairment and hedging are not known. Finally, we are concerned that this three step approaches will only lead to a new standard on classification and measurement before 2009 yearend. Therefore, the IASB runs the risk not to answer some of the key concerns expressed by several stakeholders (ie the G20).

Finally, as European insurers, we strongly support global convergence. For this reason, we are concerned that the IASB and the FASB seem to be working on different timetable and have reached different tentative views so far. From our point of view, it is crucial that the IASB and the FASB end up with standards for financial instruments which are based on the same mix measurement attribute model.

A model based on two categories

We are generally supportive of the two-bucket approach designed by the IASB, with a classification based on a mixture of the characteristics of the instrument and of the business model. While we support an economic market consistent balance sheet and, accordingly, we recognize the merits of market consistent values for financial instruments, we believe that there are business models or circumstances that justify the use of amortised cost. For example, this could include situations in which insurance liabilities based on the current IFRS 4 are not accounted for on a market consistent basis. Therefore, we support a mix measurement attribute model. Nevertheless, we have significant issues with both categories and their implication on valuation.

Amortised cost category

We believe that the conditions imposed by the IASB to be eligible to the amortised cost category are too stringent and ambiguous. This ambiguity in the exposure draft should be addressed in order to avoid genuine implementation problems. We fully agree that complex bond securities with significant leverage should not be valued at amortised cost, since they amplify the variability of cash flows with the result that those cash flows do not have the economic characteristics of interest. However, we believe that, for example, the limitation to only the most senior tranche of a waterfall structure is excessive. This criterion will allow amortised cost classification for financial instruments encompassing credit and interest rate risk but no leverage such as perpetual. We encourage the IASB to add some flexibility in the criteria for eligibility.

Fair value category

We believe that for complex bond instruments and equities the fair value is valuable for users of financial statements. However, we believe that the business model of a company should drive the presentation of changes in those fair values. Indeed, if the business model of a company is to invest (in a bond or equity instrument) with a long term horizon in order to match their liabilities (as it is often the case for insurance companies), it should be permitted to record the changes in the fair value of those investments in OCI even in bonds and not only in equity instruments as already allowed in the ED. Indeed, the short term fluctuations of the fair value of those assets are not predictive of future cash flows for users of financial statements, as they will not be realised in the near future. On the contrary, if the business model of a company is to actively trade their investments or if the business model is to manage those assets on a fair value basis, changes in the fair value of those assets should be recorded in the profit and loss account. Asset and liability management underlies an insurers' business model and therefore the asset valuation basis should include consideration of the corresponding valuation of liabilities reflecting the fact that insurers seek to manage and match both sides of the balance sheet. There remains significant uncertainty over the outcome IFRS 4 Phase II for insurers which will determine the basis of measurement for insurance contracts and hence it is not possible to fully assess the implications of the proposals for financial instruments on insurers until Phase II proposals are clearer.

In addition, we believe that movements recorded in OCI (unrealised gains or losses) should be recycled when realised, as in the AFS category under current IAS 39. Indeed, realised gains or losses are an integral part of the performance of the company and are due to be eventually distributed either to the policyholders (for instance in the case of assets backing insurance contract with participating benefits) or to the shareholders. Similarly, dividends received on financial instruments classified at 'fair value through OCI' should be recorded in the profit and loss account. Not to show those movements in the profit and loss account would not provide a faithful representation of the performance of the company.

In addition, it would generate an accounting mismatch for some companies. Indeed, in many European countries, insurance companies are legally or contractually obliged to distribute or allocate to their policyholders a certain minimum percentage of the realised gain or loss on disposal of an asset which covers those contracts. It is therefore important that companies are allowed to book both the realised gain or loss in the income statement and the corresponding increase or decrease in the insurance liability to avoid an accounting mismatch.

We acknowledge that the possibility to recycle would then necessitate that the IASB sets impairment rules. As we have expressed in our correspondence to the IASB in the past year, if recycling is allowed and hence an impairment review is applicable to the FV through OCI category, we believe that the impairment rules for instruments accounted for in that category should be improved compared to the impairment on current 'available for sale' instruments, for example by including the notion of holding horizon or by allowing the reversal of the impairment through the profit and loss account.

Fair value option

In the context of the current IAS 39, insurance companies have used the fair value option (the "FVO") in order to reduce an accounting mismatch but also in circumstances where there was no such mismatch. It is critical that the new standard allows companies to use the FVO in the same situations as companies currently use it.

One could read the ED as requiring financial assets to be categorised as amortised cost given that they are managed on a contractual yield basis despite the fact that the overriding investment strategy is one of fair value (this can be the case in some non-life business for example). We do not believe that the IASB intended to restrict the ability to use the FVO further than current IAS 39 allows and would recommend that the final standard is revised to avoid any unintended consequences.

Reclassification

Firstly, we believe that companies should be allowed to reclassify financial instruments across categories (and between fair value through profit and loss and fair value through OCI). Those reclassifications should not be a free choice of management but should be limited to changes in business model (or reallocation of an asset between two business model inside one company – for example between a life product and a non-life product) or in responses to external factors outside the control of the company (for instance a policyholder that requires that his unit link contract is transformed into a guaranteed interest rate contract with participating benefit).

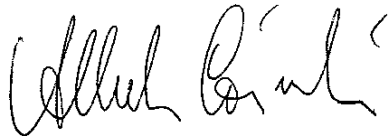
In addition, it is fundamental that, if the final standard for classification and measurement is implemented before the phase II for insurance contract is implemented, insurance companies are allowed to revisit the classification of all their financial instruments upon application of the future standard for insurance contract. Indeed, it would be unreasonable to take irrevocable decisions when such an important project for insurers is still on development.

Mandatory application date and transition arrangements

With the European Union adopting IFRS for consolidated accounts of listed companies in 2005 and the proposed IASB time table (the new financial instruments standard to be mandatorily adopted by 2012 and the insurance contract standard to be implemented in 2013), European insurance companies will have been exposed to successive significant changes over 10 years. Those changes trigger significant work for preparers but also need to be explained to users of financial statements. Therefore, we urge that the IASB either extend the transitional period (with possible early adoption) of the final standard on classification and measurement until the implementation of the future standard on insurance contract (currently expected in 2013) or allow a “sunset clause” to enable the continuation of the current AFS category until Phase II is adopted.

We hope you will find those comments useful. Our responses to the questions raised in the ED are attached in appendix to this letter. As expressed in the introduction to this letter, the financial instrument project is of fundamental importance for our industry. We are committed to remain engaged with the IASB on those issues. Do not hesitate to contact us should you have any question,

Yours sincerely,



Alberto Corinti
CEA Deputy Director General/Director Economics & Finance

Appendix - Financial Instruments: Classification and Measurement

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 may provide decision useful information in cases where the business model of the company consist in managing the instrument on a contractual yield basis (ie for the principal and the interest).

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?

No, the Exposure Draft as drafted does not provide sufficient operational guidance in this respect. We believe that the exposure draft is sometimes ambiguous when describing the business model as a condition for the amortized category. We believe that this ambiguity should be addressed in the final standard in order to avoid genuine implementation problems.

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?

We support the criteria set up by the IASB to for an instrument to be eligible for the amortised cost category (‘simple loan’). However, we believe that the limitation to instruments that do not have any leverage is too restrictive. We believe that the amortised cost category should be opened to instruments that do not have significant leverage. The determination of what is a significant leverage should be matter of professional judgment. When exercising this judgment on significant leverage, both the contractual terms and the economic substance of instruments should be considered

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.

We support bifurcation of the embedded derivatives and its financial host contract when their characteristics and risks are not closely related. Indeed, we believe that there is valuable information to users is disclosing the specific features and value of those two elements separately in the financial statements. However, in cases where it is impracticable or arbitrary to bifurcate the two elements, it should be permitted to consider the instrument in its entirety.

(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 decision usefulness of information about contractually subordinated interests?

In line with our response to question 3, we believe that the amortised cost category should be extended to loans without significant leverage. Therefore, 'contractually subordinated interests' should be assessed on a case by case basis to determine if they contain significant leverage. For example, we believe that in some waterfall structures, more than just the most senior tranche could be eligible to the amortised cost category.

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?

Yes, we fully support that the fair value option is maintained in order to reduce an accounting mismatch. In addition, we believe that if the circumstances that justified the use of the fair value option on initial recognition disappeared, preparers should be allowed to reclassify the instrument.

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?

We support an unconditional fair value option. Indeed, if management of a company believes that the fair value an instrument, be it a simple loan instrument or not, contains more decision-useful information for users, management should be allowed to use fair value in all cases.

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?

We believe that companies should be allowed to reclassify financial instruments across categories (and between fair value through profit and loss and fair value through OCI). Those reclassifications should not be a free choice of management but should be limited to changes in business model (or reallocation of an asset between two business model inside one company – for example between a life product and a non-life product) or in responses to external factors outside the control of the company (for instance a policyholder that requires that his unit link contract is transformed into a guaranteed interest rate contract with participating benefit).

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 is the most decision-useful measurement attribute for equity instruments (and related derivatives). However, we believe that changes in fair value should not automatically be booked in profit and loss. Indeed, if the business model of a company is to invest with a long term horizon in order to match its liabilities (as it is often the case for insurance companies), it should be permitted to record the changes in the fair value of those investments in OCI. Indeed, the short term fluctuations of the fair value of those assets are not predictive of future cash flows for users of financial statements, as they will not be realised in the near future. On the contrary, if the business model of a company is to actively trade their investments or if the business model is to manage those assets on a fair value basis, changes in the fair value of those assets should be recorded in the profit and loss account.

Nevertheless, we firmly support maintaining the current cost exemption for investment in equity instruments that do not have a quoted market price in an active market and whose fair value cannot reliably be measured.

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?

Not answered.

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?

As discussed in the answer to question 8, the CEA believes that fair value is the most decision-useful category for equity instruments. Nevertheless, the recognition of changes in the fair value attribute should be based on the business model of the entity. We believe that dividends and realized gains and losses on investments are an integral part of the performance of a company and therefore should be recycled. In order to present a faithful representation of the performance of the company, gains and losses on those instruments classified in fair value through OCI should be recycled in the performance statement on realization. Similarly, dividends on those instruments should be recorded in the profit and loss account when earned.

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,

We believe that if the circumstances that lead to the initial classification of an instrument in one category changed (by example due to a change in the business model of the company), the company should be allowed to reclassify this instrument. This should be permitted for instruments initially classified in fair value through profit and loss (as a result of the fair value option or not) and instruments classified in amortised cost category.

(a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

Refer to our answer to questions 8 and 10.

(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?

Refer to our answer to question 8 and 10.

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?

Not answered.

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?

We believe that comparative figures should not be required to be restated when first applying the future standard on classification and measurement for financial instruments.

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

- a) 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 from IAS 39 are implemented
- b) Changes to comparatives, on three occasions over a period of two years (each time the revisions to IAS 39 are implemented) would cause tremendous confusion for users of the financial statements
- c) 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
- d) 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

However, if companies have the relevant data and believes that the benefit of restating exceed the costs of restating, those companies should be allowed to restate comparatives figures.

We support the proposal in the ED to record an asset at its original historical cost when an entity transfers an asset from current 'available for sale' category to the new 'amortised cost' category when first applying this new standard.

We also would like to emphasise the interaction between this new standard and other major IASB projects. In particular, the IASB is developing the phase II for insurance contracts, expected to be implemented in 2013. This project is likely to have an impact on the classification of financial instruments and therefore it is crucial that companies are allowed to revisit the classification of financial instruments covering insurance liabilities when the future insurance contract standard is first time implemented.

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?

Not answered.

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?

Not answered.