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<u>Reference: IASB Exposure DRAFT "Financial Instruments: Classification and Measurement"</u>

Dear Sir David,

CEIOPS welcomes the opportunity to comment on IASB's Exposure Draft on Financial Instruments: Classification and Measurement (ED).

Firstly, we would like to express our general support to this ambitious project of IASB as we see merits in the simplification of the accounting for financial instruments. Moreover, CEIOPS greatly appreciates IASB's commitment in addressing the concerns raised by several institutions in Europe regarding accounting solutions in response to the financial crisis and in making an effort to identify long-term global solutions.

Following the Joint statement from CESR, CEBS and CEIOPS, where the three Committees expressed their willingness to "*remain ready to contribute to an appropriate and consistent application and development of measurement and disclosure requirements within their respective fields of competence*", in this response we intend to focus on those issues that are of particular relevance for the insurance sector, especially under the Solvency II project, in an attempt to focus on the insurance specificities that should be taken into account by the Board when publishing a final standard on financial instruments[1].

While recognising that the perspective and objectives of Solvency reporting and general purpose financial statements are often different, CEIOPS is keen to achieve a regulatory reporting regime under Solvency II that is aligned as far as possible with International Financial Reporting Standards. Considering this purpose and the fact that financial assets form a substantial part of an insurer's balance sheet, we have a special interest in this ED together with developments on the IASB project on Insurance Contracts.

The issues that are important for insurance business under the Solvency II project are briefly summarised below as follows:

1. Reconciliation between Solvency II regime and Accounting

CEIOPS understands the merits of having a mixed-attribute model for the valuation of financial instruments in general purpose financial statements.

However, at the foundation of the valuation principles in Solvency II lies the economic market consistent valuation principle consistent with IASB's fair value principle.

There are significant practical benefits when accounting standards and regulatory requirements are aligned as far as possible. It is equally important to enable insurance undertakings to use IFRS as a basis for regulatory reporting under Solvency II with reduced number of solvency adjustments especially when the Phase II of the IFRS on Insurance Contracts will be finalised in the following years.

To the extent differences continue to exist between solvency reporting and general purpose financial statements, CEIOPS considers it important to clearly identify and publicly disclose such differences. This implies strengthening the disclosure requirements, especially on the valuation of assets and liabilities that are not fair valued and the risks that they carry.

This issue is linked to the following two points.

2. Timing adoption and timing implementation issues

We find it difficult to assess the proposed classification and measurement proposals without reviewing other parts of the IAS 39 replacement project (impairment recognition and hedge accounting) and other related projects. This is particularly critical for insurance undertakings insofar as the main decisions concerning the Phase 2 IFRS 4 have not been taken by the two Boards (IASB and FASB).

Another consequence of the timing difference will be that insurance undertakings will possibly need to reclassify twice, once following the adoption of the new IAS 39

[1] *CEIOPS 3L3 16-08* – "Joint Statement from CESR, CEBS and CEIOPS regarding the latest developments in accounting*".* In the note, the three Committees also stated the following*: "In particular, they plan to contribute on the issues of the fair value option, embedded derivatives, insurance questions, and any other issues of concern in IAS 39 and IFRS 7, in order to find appropriate solutions in the public interest, taking into account an appropriate level of transparency, as requested by the European Commission in its statement dated 15 October 2008".*

amendments and next following the IFRS 4 Phase 2 adoption. This will entail practical difficulties for supervisors who already rely on IFRS-based reporting for their solvency assessment.

We are aware that the IASB acknowledges these difficulties; indeed the BC2 of the ED explicitly mentions the likely differences in timing between the two projects. Nevertheless, we would like to stress again our strong view that a key priority for the IASB should be the completion of a full standard for accounting for insurance contracts.

Given the expected timing of mandatory application of both IFRS 4 and IAS 39 amendments are not very different, we urge the Board to consider the differences in timing between both projects (e.g. allowing for simultaneous application).

3. Fair value option

Another aspect, linked to the first one, is on the fair value option that is proposed to be retained in the ED but restricted to be used in cases where the application of fair value to the asset or liability in question eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch) that would otherwise arise.

CEIOPS is concerned that this restriction on the use of the fair value option could potentially limit application of fair values on specific instruments, like debt securities, by making it uncertain whether the option is available or not. Depending on the characteristics of IFRS 4 Phase II, this is likely to become an important source of accounting mismatch for insurances undertakings.

It is likely that the forthcoming Phase II measurement principles will imply that market fluctuations, especially in interest rates, will be reflected in the value of insurance liabilities and thereby impact profit and loss. It is therefore important to retain the possibility to fair value financial assets in order to prevent accounting mismatch in the context of insurers' business models.

4. Classification approach

We agree with the proposed simplification on classification requirements with only two categories of financial instruments.

Whilst CEIOPS appreciates the examples given by IASB in B12 and explanation provided in BC33, additional guidance should however be developed on the application of the concepts of 'basic loans features' and 'managed on a contractual yield basis' in order to foster consistent application of the new standard.

We are also concerned about the guidance on business units, which does not seem to correspond to the current practice of the insurance industry. It is not clear at which level the ED intends the condition 'managed on a contractual yield basis' to be applied. Does it have to be based on business units or should it be applied more narrowly than that on a portfolio basis?

Clarifications could also be made on the 'contractual yield basis' criterion, for instance if an entity matches durations of the assets and liabilities in asset/liability managed portfolios rather than orienting itself for holding instruments in such portfolios until maturity, will the 'managed on a contractual yield basis' still be met?

5. Fair valuation for equity instruments

Consistent with the economic valuation principle of Solvency II, CEIOPS agrees with the IASB that a decision-useful information on investments in equity instrument results if such investments are measured at fair value. It is a well known fact that the recent crisis highlighted the difficulty in reliably estimating the fair value of financial assets like equity instruments when the markets are illiquid or inactive. CEIOPS acknowledges and supports the fair value principle applied for equity instruments and encourage the IASB to develop further principles and guidelines (in addition to IASB's Expert Panel paper of October 2008) to be applied to achieve a reliable valuation.

6. Embedded derivatives

CEIOPS agrees with the ED in proposing the same classification approach for all financial instruments, including those with embedded derivatives. Consequently, instruments with embedded derivatives should be measured at fair value unless the derivative component does not violate the basic loan feature of the entire instrument.

However, CEIOPS finds that where the host is within the scope of this ED, bifurcation should be allowed as an option in some circumstances (e.g. when it is clear that the derivative and the host instrument are not interconnected and can be separated without introducing complexity in the measurement of both derivative and the host instrument). To avoid misuse of this bifurcation CEIOPS will appreciate detailed guidance to be developed, including better disclosure requirements.

7. Reclassifications

The ED proposes to prohibit reclassification of financial assets and financial liabilities between the amortised cost and fair value categories.

CEIOPS appreciates the underlying objective of prohibiting reclassification is for firms to be very clear upfront in determining the category in which the financial asset and financial liability will be classified. However, prohibition of reclassification appears to introduce a contradiction to the primary objective to classify instruments according to the business model.

CEIOPS would therefore support that reclassifications could take place in rare circumstances where the conditions for classification at initial recognition are no longer met. Reclassifications should only be allowed prospectively (from date of decision on change in business model) and appropriate disclosures should be required. To avoid misuse CEIOPS will appreciate guidance to be developed for the use of reclassification in such rare circumstances.

If you have any questions or wish to discuss all this further with us, please feel free to contact jarl.kure@ceiops.eu.

Best regards,

Thomas Steffen

CEIOPS Chair