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Sir David Tweedie
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Reference: IASB Discussion Papers "Reducing Complexity in Reporting Financial Instruments" and "Financial Instruments with Characteristics of Equity"

Dear Sir David,

CEIOPS welcomes the opportunity to comment on the IASB's Discussion Papers

1) Reducing Complexity in Reporting Financial Instruments; and
2) Financial Instruments with Characteristics of Equity.

As you may be aware, due to our own work on the Solvency II project, we have a special interest in these discussion papers together with the important IASB Discussion Paper "Preliminary Views on Insurance Contracts". CEIOPS is keen to achieve a reporting regime under Solvency II that is aligned as far as possible with International Financial Reporting Standards. As such, CEIOPS strongly supports the IASB's continued work in these discussion papers and the development of an accounting standard for insurance contracts.

In this response we intend to focus on those issues raised that are of particular relevance and importance for the insurance business under the Solvency II project.

In particular, we would like to stress the importance of the challenges in applying the fair value principle highlighted by the current market turmoil. We believe further meaningful discussions could take place in relation to:

- ·When is a market active, when is it inactive?

- ·When is a transaction considered to be forced or distressed and consequently its price is considered not to be fair value?
- ·How are inputs in a valuation technique (mark-to-model) selected?

CEIOPS notes the recent initiative by IASB to form an expert advisory panel to discuss the valuation of financial instruments in inactive markets and is looking forward to the results of this work as clear and consistent answers to these questions are needed.

We hope you find this letter a useful and relevant contribution on the discussion papers. If you wish to receive further clarifications, CEIOPS would be happy to respond.

Yours sincerely

Thomas Steffen

CEIOPS Chair

Annex 1

REDUCING COMPLEXITY IN REPORTING FINANCIAL INSTRUMENTS

Introductory Comments

In principle, CEIOPS supports the IASB's objective of reducing the complexity in reporting of Financial Instruments.

We also wish to express our support for the efforts to identify the main causes of complexity in IAS 39 and start a discussion on the *long-term* solution. Our detailed comments relating to some of the questions raised are set out below. However, to summarise our key views:

- CEIOPS believes that there are significant practical benefits if accounting standards and regulatory requirements are aligned as far as possible. Under Solvency II, insurance liabilities are foreseen to be measured on a market consistent economic basis, calculated in a prudent, reliable and objective manner. All financial assets and other liabilities are intended to be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction. Unrealised gains and losses on liabilities relating to an entity's own credit standing are not recognised.

  Therefore CEIOPS recognises that there are benefits with the long-term objective of using a fair value principle to measure financial instruments in published financial statements that is consistent with the general measurement framework foreseen under Solvency II. The discussion paper underlines a number of concerns that must be addressed before a general fair value measurement requirement could be introduced. Some of the concerns relate to concurrent IASB projects such as Financial Statement Presentation and Fair Value measurement.

- CEIOPS believes that it may be more appropriate to issue one set of accounting changes that are foreseen as being complete and long-lasting, instead of introducing phased accounting rules that may undermine the objective of having more understandable information (adding uncertainty surrounding the next standard's change). Furthermore, CEIOPS believes that an analysis of the cost-benefit relationship should be undertaken in order to conclude if the benefits of reducing IAS 39's complexity in multiple phases outweighs the costs. CEIOPS also understands that the IASB needs to adopt a measurement basis for assets and liabilities that allows reporting entities to provide useful information to users of general purpose financial statements. Considering the scope and complexity of the measurement issue, CEIOPS encourages the IASB to open a comprehensive debate about measurement of financial instruments and not to address the issue through the limited objective of reducing complexity in reporting financial instruments. The work could usefully take place within the context of the conceptual framework project.

- CEIOPS wishes to re-state its strong support for the IASB in undertaking the insurance contract project and urges IASB to prioritise this project on its agenda.

Responses to Questions for Respondents

Questions 1, 2, 8, 9, 10 and 11

Question 1

Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the IASB respond to assertions that the current requirements are too complex?

Complexity is likely to be perceived differently by different stakeholders; a simple solution may not be available or appropriate. Due to the dynamic and changing nature of financial instruments current requirements may not continuously meet the concerns of preparers and their auditors and the needs of users of financial statements. The IASB might address this through a more principled focused approach to maintain relevance in a changing environment. This issue is not limited to financial instruments and work could usefully take place within the context of the conceptual framework project.

Question 2

(a) Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.

CEIOPS believes that it may be more appropriate to issue one set of accounting changes that are foreseen as being complete and long-lasting, instead of introducing phased accounting rules that may undermine the objective of having more understandable information (adding uncertainty surrounding the next standard's change).

Intermediate measures should be considered only in exceptional circumstances. Furthermore, CEIOPS believes that an analysis of the cost-benefit relationship should be undertaken in order to conclude if the benefits of reducing IAS 39's complexity in multiple phases outweighs the costs.

CEIOPS does not consider that proposed intermediate changes would be consistent with all of the IASB's criteria noted in paragraph 2.2 of the Discussion Paper.

(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?

The criteria in 2.2 are welcome. We note:

- In relation to criteria a) CEIOPS would respectfully suggest that meaningful financial results should not include accounting volatility, that is, volatility arising as a consequence of application of inconsistent measurement bases that is not reflective of the underlying business economics of the entities. Accounting volatility jeopardises the overall objective of relevance and understandability.

- It is possible that criteria c) is implied by criteria a) and d). Complexity is an impact of the change that has to be evaluated in terms of the user's willingness to pay for it or willingness to pay to avoid it.

Questions 8/9

8. To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments.

Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?

9. Part A of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.

(a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?

(b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?

CEIOPS believes that there are significant practical benefits if accounting standards and regulatory requirements are aligned as far as possible. Under Solvency II, insurance liabilities are foreseen to be measured on a market consistent economic basis, calculated in a prudent, reliable and objective manner. All financial assets and other liabilities are intended to be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction. Unrealised gains and losses on liabilities relating to an entity's own credit standing are not recognised.

Therefore CEIOPS recognises that there are benefits with the long-term objective of using a fair value principle to measure financial instruments in published financial statements that is consistent with the general measurement framework foreseen under Solvency II.

At the same time, considering the scope and complexity of the measurement issue, CEIOPS encourages the IASB to open a comprehensive debate about measurement of financial instruments and not to address the issue through the limited objective of reducing complexity in reporting financial instruments. The issue is not limited to financial instruments and work could usefully take place within the context of the conceptual framework project.

Questions 10

Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?

The current market turmoil has highlighted challenges in applying the fair value principle. We believe further meaningful discussions could take place in relation to:

- When is a market active, when is it inactive?
- When is a transaction considered to be forced or distressed and consequently its price is considered not to be fair value?
- How are inputs in a valuation technique (mark-to-model) selected?

CEIOPS notes the recent initiative by IASB to form an expert advisory panel to discuss the valuation of financial instruments in inactive markets. CEIOPS is looking forward to the results of this work as clear and consistent answers to these questions are needed.

One specific point that CEIOPS wishes to reiterate is that unrealised gains and losses on liabilities relating to an entity's own credit standing should not be recognised.

Questions 11

Part C of Section 3 identifies four issues that the IASB needs to resolve before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments.

(a) Are there other issues that you believe the IASB should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the IASB address them?

(b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?

The four issues that the IASB highlights that it needs to resolve include Presentation, Disclosure, Measurement and Scope.

In relation to presentation, CEIOPS would reserve judgement until there are revised proposals, although *prima facie* presentation would appear to be a significant aspect in the preparation and interpretation of financial statements. At that point it would be more appropriate to comment on how the effects of changes in fair values of certain instruments should be reflected in earnings.

In relation to disclosure, CEIOPS notes the recommendations of the Financial Stability Forum (FSF) in relation to improvements in disclosures about valuations, methodologies, uncertainty associated with valuations, quality of disclosures about valuations, valuation methodologies, price verification processes and the uncertainty associated with valuations. CEIOPS supports the recommendations and any proposals should reflect these recommendations.

In relation to Measurement and Scope, CEIOPS is guided by Solvency II principles, under which insurance liabilities are foreseen to be measured on a market consistent economic basis, calculated in a prudent, reliable and objective manner. All financial assets and other liabilities are intended to be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction.

Annex 2

FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

Introductory Comments

CEIOPS has an interest in the IASB's Discussion Paper *Financial Instruments with the Characteristics of Equity* which included preliminary views on this subject developed by the US Financial Accounting Standards Board. This interest arises because certain components of regulatory capital are closely aligned with the current accounting definition of equity. Moreover, in our work on the Solvency II project, CEIOPS seeks to achieve a prudential solvency regime that is compatible, as far as possible, with IFRS. As you are aware, elements of insurance undertakings' solvency reports may be publicly disclosed, so there is a potential issue that different signals could be conveyed by general purpose and prudential reporting.

Rather than address each of the questions raised by the Board, we prefer to comment on a number of key issues.

Prioritisation and timing of the project

While we acknowledge that there are a number of shortcomings with the current standard IAS 32, we are not convinced that these are sufficiently significant as to require a full review of the approach to distinguishing between equity and liabilities. The Discussion Paper notes various issues surrounding IAS 32, but it does not provide evidence that these are creating widespread problems for preparers or users of IFRS accounts. Our own sense is that for many entities these issues are not significant in practice.

Particularly against that background, we would like to underline again our strong view that a key priority for the IASB should be completion of a full standard for accounting for insurance contracts. The absence of such a standard is a major gap in IFRS at present.

In our view this project has a lower priority than both completing a full standard for insurance contracts, and dealing with the issues under the expert advisory panel on valuation of financial instruments.

Conceptual foundations

In our opinion, a fundamental issue with the documents produced by the FASB and the IASB is that they do not discuss what overall principles should underlie the distinction between equity and liabilities. We assume that this issue will be considered as part of Phase B of the project on the Conceptual Framework, but we note that the IASB does not expect to publish a discussion paper on that phase until the second half of next year. In the absence of agreement on the conceptual distinction between equity and liabilities, we think it is difficult to evaluate the particular approaches set out in the documents.

A further issue in the published documents is that they deal only with the distinction between equity and liability instruments, and not with other fundamental components of capital such as retained earnings and reserves.

We also think that the standard setting boards should consider in more detail, and discuss in their due process documents, the loss absorption approach as a further possible way of improving the existing IAS 32. One advantage of the loss absorption approach is that it is based on a clear conceptual framework.

The proposed approaches

Below we discuss the Basic Ownership and the Ownership-Settlement Approaches. We do not consider the Reassessed Expected Outcomes approach as we believe that it would be too complex to be capable of practical implementation and would appear to add complexity in reporting financial instruments.

(i) Basic Ownership

In our view this approach has the considerable merits of simplicity and focuses on the highest quality and most subordinated form of capital. While by its nature it delivers a relatively narrow view of 'equity', that could be helpful in clearly identifying the most subordinated element of the capital structure of a firm, including insurance undertakings.

On the other hand, we do think that in some circumstances the Basic Ownership Approach could be misleading in the sense that an entity may issue a range of instruments all of which are intended to provide 'capital' which protects creditors of an undertaking (including insurance policy holders) – and yet only the *most* subordinated would qualify as equity.

We are also unclear about the treatment of reserves. At present, many entities have 'equity' or 'shareholders funds' which includes not only capital instruments, but also retained earnings and various reserves, such as fair value reserves and revaluation reserves. A very important issue is whether retained earnings and these reserves would be included in equity. Another question concerns the treatment of non-controlling interests.

A further issue is how to deal with a situation in which there is a <u>group</u> of 'most subordinated' instruments, which rank equally with each other, and below all other claims, but differ in certain other respects. Would all of these be regarded as Basic Ownership instruments?

(ii) Ownership-Settlement

This approach would allow a wider range of 'capital instruments' to be included in accounting equity. However, we see a number of problems with the Ownership-Settlement approach as currently described.

First, we are not comfortable with the idea that any perpetual instrument would qualify as equity, even if it is not subordinated. In our view, one of the most important criteria in the definition of equity is a notion of subordination, or residual claim, which conveys useful information to creditors regarding the net assets likely to be available to protect their claims. Arguably the criterion of subordination is implicit in the current IAS 32 in that an equity instrument is defined as 'any contract that evidences a residual interest', and it cannot represent an obligation to deliver an outflow of economic resources. However, that approach would be lost if equity were widened to unsubordinated instruments. Any such broadening would seem to have more to do with some notion of permanence of funding, rather than the traditional interest in balance sheet strength.

We understand that the approach would also include within the definition of equity various 'indirect ownership instruments', defined as instruments settled by issuing related basic ownership instruments. While we appreciate the rationale in terms of the link to basic instruments, we are not sure that users of accounts would find it helpful for these indirect ownership instruments to be included in equity. We understand that these would essentially be derivatives on an entity's basic ownership instrument, or on other features of an entity's operations. This raises the question of whether it is helpful to include derivatives in 'equity'. We appreciate that this issue also arises in the existing IAS 32, and would suggest that the standard setters give further thought to the conceptual issues surrounding the question.

Conclusion

In our view, the IASB's Discussion Paper does not establish a robust basis for revising IAS 32. In reviewing IAS 32, further thought on the conceptual distinction between equity and liabilities will be required. This might enable the issues identified above concerning the Basic Ownership and Ownership-Settlement approaches to be comprehensively addressed.