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Dear Sir David

**Reclassification of financial assets out of “designated at fair value through profit and loss” category**

This letter is drafted by the European Insurance CFO Forum, which is a body representing the views of 20 of Europe’s largest insurance companies. It represents a consensus view on issues relevant to the European insurance industry. This letter provides further detail on one of the issues raised in our letter of 10 October and is intended to supplement the letter issued by the European Commission to the IASB on 27 October 2008.

We stated in our letter of 10 October our concerns with the continued application of mark-to-market accounting for those financial instruments for which there is no longer substantial market liquidity given that mark-to-market values can be significantly lower than the genuine economic value of the positions. Furthermore, we noted that accounting classification and business intent are no longer aligned and that the assessment of solvency is also impacted by current accounting rules. Therefore, in that letter, we proposed some measures designed to reflect the business intent and the value of the instruments held and therefore attempt to dampen the negative spiral of the current crisis.

We would like to take this opportunity to reinforce our view on one particular issue raised at that time (and by the European Commission in their letter of 27 October) that we regard as a priority. We urge the IASB to allow reclassification, at fair value on the date of transfer, from the “fair value through profit and loss” (FVTPL) category to another category for both trading assets **and** assets designated at fair value by option if there is an unequivocal change in business intent to hold the instruments as a result of the lack of market liquidity. Moreover, reclassification of trading assets or assets designated at fair value by option from the FVTPL category to another category should be allowed when there are changes in business model in response to ‘hexogen’ factors, for instance, when the market conditions no longer permit entities to manage the assets and have the corresponding performance evaluated on a fair value basis or in newly created mismatches situations.

The fair value option can be used under very specific circumstances, mainly in cases of mismatches, the application of asset and risk management strategies based on fair value, or the existence of embedded derivatives. In addition, the election of the fair value option is also limited to those cases where fair value can be determined reliably. **The rationale behind the reclassification of assets out of the financial instruments measured at fair value upon inception category is that there should be a possibility to reclassify such assets under the rare circumstances where *the conditions which permitted the financial instruments to be designated at fair value through profit or loss at inception are no longer met.*** Such circumstances include precisely the current market environment, where especially assets and risk management strategies were strongly modified over recent months.

We would therefore fully support reclassifications of financial instruments from the fair value option category, either into assets Held-to-maturity, Available-for-sale or Loans & Receivables. **Such reclassifications would not only be in line with the existing underlying rationale behind the IAS 39 designations, but would also allow a better reflection of the economic reality and asset management strategy of companies.** Keeping assets under the categories elected upon acquisition when the precise reasons for which such elections were made possible no longer exist could mislead investors and could result in an aggravation of the current downward spiral of extreme volatility, increase in spreads, asset value decreases and negative earnings, given the weight of insurance companies in the economy. Finally, IFRS asset classification also may have impacts on the solvency assessment of companies as in some jurisdictions unrealised losses on bonds are considered as permanent when they relate to assets designated as at fair value through profit or loss.

In terms of cost-benefit analysis, such amendments and additional guidance remain in line with the IFRS principles underlying the current IAS 39 standard and do not represent a departure from the current Framework, while allowing for less pro-cyclical effects.

We believe that this proposal should represent a global solution to a global problem and therefore both the IASB and FASB should include it in their accounting standards.

It is also imperative that this proposal is adopted as an immediate solution and it is our strong preference for these changes to be enacted by the IASB.

We have set out in the appendix to this letter some further detail on why reclassifications out of the designated as fair value through profit and loss category should be permitted, including examples of particular situations applicable to insurers.

We remain at your disposal should you have any questions on the examples set out in the appendix.

Yours faithfully



Denis Duverne, Chairman  
European Insurance CFO Forum

### Why do insurers want reclassifications out of the fair value option to be possible?

There is, following the recent IAS 39 amendment, a level playing field issue as reclassifications have recently been allowed for Trading assets more used by banks and not assets designated under the fair value option more widely used by insurers.

But apart from this issue which results from the recent IAS 39 amendment, there are reasons linked to the nature of assets and policyholders liabilities carried on the balance sheet of insurance companies and the impact of the credit crisis.

### Use of the fair value option by European insurers

Insurers largely use the fair value option in their financial statements since transition to IFRS and still intend to do so, even in the current crisis, when relevant. This option is used in the following cases:

#### *To address mismatches*

#### Measurement of unit-linked assets backing unit-linked contracts

- In most “previous GAAP’s” under which insurers currently report during Phase I of the IFRS insurance contracts project, unit-linked liabilities reflect the fair value of assets backing such contracts. The measurement of these liabilities is not necessarily at fair value as most insurers recognise deferred acquisition costs and other features which would not be part of a fair value measurement attribute. However, the measurement of the core policyholders liabilities and related assets are usually identical. There is no intention to reclassify assets backing unit-linked contracts out of the fair value option category.

#### UK With Profits contracts

- The same kind of circumstances led UK based entities to designate their assets backing with profits contracts at fair value through profit or loss.

#### Hedged assets or liabilities

- To achieve a ‘natural hedge’ the underlying assets or liabilities can be designated as at fair value through profit or loss while the changes in fair value of the derivatives ‘naturally’ flow through earnings. This is easier to implement than IAS 39 hedge accounting.

#### Debts financing investments

- For example, in consolidated CDO’s where assets were designated under the fair value option because they are managed and their performance is evaluated on a fair value basis (see below) or contain embedded derivatives, debts may be designated at fair value through profit or loss to avoid any mismatch.

#### *Assets for which management and evaluation of performance are performed on a fair value basis*

Investments reflecting a strategic asset allocation based on a dynamic asset management approach aimed at maximizing returns.

- The turnover of such assets was too slow to lead to a designation as trading assets and trading activities as such are rarely part of an insurer’s normal course of business. In this context, at the time of transition to IFRS, some companies elected to use the fair value option for some specific assets managed and for which the evaluation was performed on a fair value basis. This was the case for credit portfolios in 2004/05 which were designated as at fair value through profit or loss to reflect ALM (Assets and Liabilities Management) strategies, while

assets that formed part of the “core investment portfolio” were generally designated as available for sale assets.

#### *Assets or liabilities containing embedded derivatives*

In order to avoid complex bifurcation it was decided to recognise the whole instrument at fair value.

#### **Cases where there is a need to reclassify such financial instruments**

##### *Assets managed and for which the evaluation is performed on a fair value basis and mismatches situations*

As pointed out above, some portfolios have been designated as at fair value through profit or loss at transition date. These were, for example, credit portfolios with investment grades assets. Credit risk needs to be carefully monitored. This usually leads to an active management approach which rules out classification in the HTM category, even though backed liabilities remain at cost (so called ‘sticky liabilities’ with locked-in assumptions in Phase I). As pointed out above, the patterns of realisation were lower than trading assets and the management of these assets was different from trading activities. However, the recognition of the changes in fair value in profit or loss was in line with the rationale behind this active management. No major changes in credit were experienced or if expected, related assets were sold. Markets of corporate bonds and assets backed securities were still deep and liquid. As a result, changes in fair value flowing through P&L included neither changes in credit risk nor liquidity risk.

When the crisis began, spreads began to widen, resulting in changes in credit and liquidity risks. This created a deeper mismatch between assets held and policyholders liabilities carried “at cost” under phase I which was not contemplated when designating such assets at fair value through P&L. In addition to this situation where the mismatch between assets and liabilities became more significant, at the same time, as markets became less active, such investments were no longer reflecting “a strategic asset allocation based on a dynamic asset management aimed at maximizing returns”, i.e. management on a fair value basis which was the reason for allowing the designation of these assets under the fair value option.

The current crisis leads to a need to also reclassify such assets as Loans & Receivables, notably for assets no longer traded in an active market as, in addition to the changes in the way such assets were behaving in the financial statements as a result of changes in credit risk and liquidity risk, the management of these assets also dramatically changed, moving from an active basis to one that, in some cases, involved no movement at all.

As an example of a particular situation, take the case of an insurer seeking to invest funds on behalf of a policyholder that invests in an asset backed loan receiving a fixed rate of interest. The loan would meet the definition of a Loan & Receivable in accordance with IAS 39. On initial recognition the insurer may have chosen to designate the loan as fair value through profit and loss under the fair value option because they believed that by doing so they would eliminate accounting mismatches. The fair value option is considered most appropriate because, under prevailing market conditions, both the loan asset and the policyholder liability respond equally and opposite to movements in interest rates. If a significant change in market conditions means that market movements in the fair value of the asset and the liability are no longer well matched then it is appropriate to allow reclassification of items designated under the fair value option in the same way as it is now permitted to reclassify items originally classified as trading. The key change in current market conditions is that credit spreads have widened and hence the asset and liability are no longer well matched on a fair value basis, even when the emerging cash flows remain well matched. In these circumstances it seems appropriate to permit reclassification of the asset as a Loan & Receivable.

As indicated above, some assets were designated as at fair value through P&L because the related liabilities that these investments were backing were measured on the basis of the fair value of the backing assets (unit-linked contracts and With Profits contracts, for example). There are cases whereby contracts are transferred from the With profits fund to the Non profits fund or where contracts are transferred from unit-linked assets to non unit-linked investments. In such cases, assets which were classified under the fair value option are still, under current IFRS principles, to be held at fair value through P&L while the policyholders' liabilities they were backing moved back to an historical cost (locked-in) basis.

### **Further specific examples**

#### **Example 1:**

Insurance companies purchase fixed income securities to hedge the interest rate sensitivity of future cash outflows associated with annuity that contains an embedded derivative, which is marked-to-market with changes in fair value recorded through the income statement. The fair value of the embedded derivative is sensitive to changes in interest rates.

In order to offset the profit or loss effects of the interest rate sensitivity of the embedded derivative liability, insurance companies elect to account for the fixed income securities "as at fair value through profit and loss" under IAS 39's fair value option. The application of the fair value option is permitted since the fair value designation eliminates or significantly reduces a recognition inconsistency that would otherwise result if the fixed income securities were accounted for as available for sale securities.

At a later date, the company implements a change in an accounting policy that provides more relevant and reliable financial results. As a result of the accounting policy change, fair value changes of the embedded derivative that are related to interest rate fluctuations are eliminated. Thus, the new accounting policy eliminates the need to offset these profit or loss effects, or to hold a fixed income security portfolio measured at fair value (i.e., accounted for under the IAS 39 fair value option). Furthermore, without a reclassification of the fixed income securities back to Available for Sale or an outright sale of the securities, an accounting mismatch will occur going forward. For example, the interest rate sensitivity of the embedded derivative would be significantly reduced while the fixed income securities backing the embedded derivative will fluctuate with interest rate changes. The resulting accounting mismatch or volatility flows through the income statement each reporting period negatively impacting the relevance and reliability of the financial statements.

#### **Example 2:**

Same set of circumstances as Example 1, except at a later date, the company implements a change to an existing insurance product such that the value of the embedded derivative is significantly reduced. As a result of the product change, fair value changes of the embedded derivative that are related to interest rate fluctuations are eliminated. Thus, the product change eliminates the need to offset these profit or loss effects, or to hold a fixed income security portfolio measured at fair value (i.e., accounted for under the IAS 39 fair value option). The implications stated above are the same.

#### **Example 3:**

A situation where capital markets are breaking down due to significant irrational market behaviour of the market participants leads to a significant decrease in the fair value of assets held by the company which had designated those assets as at fair value through profit or loss. Because of the psychological overreaction at the capital market the market value of the assets does not reflect the valuation which market participants could reasonably expect when they were acting in a rational manner. Classifying those assets still in the "at fair value through profit and loss" category would lead to results in the company's financial statements which are not reliable any more and would provide less relevant information to the capital market.