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Reference: IASB Exposure Draft "Fair Value Option for Financial Liabilities"

Dear Sir David,

CEIOPS welcomes the opportunity to comment on IASB's Exposure Draft on the Fair Value Option for Financial Liabilities ('the ED'), which was issued in May 2010.

Background and general comments

As expressed in previous CEIOPS comment letters to the IASB we continue to support the IASB's intention to address perceived complexities in the accounting for financial instruments and in this context we welcome the invitation to provide feedback to the Board on its proposals.

The ED sets out proposals for the measurement of financial liabilities to which an entity elects to apply the fair value option, in particular proposing that the effects of changes in the own credit risk of such liabilities should be reported in statement of comprehensive income. Other classification and measurement requirements for financial liabilities remain the same as those presented in IAS 39.

CEIOPS' concern remains focused on the potential impact of proposed changes to financial reporting at the same time that many European insurers and their regulators are, in addition, faced with the challenges of implementing the new Solvency II regime.

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 intention, we have a special interest in this ED together with other financial instrument-related developments and the IASB project on Insurance Contracts.

In this context, CEIOPS notes that it is not possible to consider the proposals of the ED in the full context in which they might eventually be expected to stand since significant parts of the project to revise IAS 39 remains uncertain or under development.

In CEIOPS' view, as required in valuation for Solvency II purposes, fair value changes in financial liabilities due to own credit risk should not be reflected in the balance sheet value of those instruments. In the absence of such an approach in IFRS, CEIOPS agrees with the proposed approach that fair value changes due to changes in an entity's own credit risk from remeasurement of liabilities designated under the fair value option should not impact profit or loss. CEIOPS finds that the proposed treatment would enable the separate identification of changes in fair value due to credit risk by users of financial statements and, as such, the proposals in the ED represent an improvement in the accounting treatment of fair-valued financial liabilities.

CEIOPS notes that in some instances the alternative approach proposed in the ED, whereby fair value changes due to own credit risk are retained in profit or loss in the event of an accounting mismatch, may provide an acceptable treatment in rare instances where the own credit risk is reflected not only in the value of the liabilities but also in the value of related assets held by the undertaking, provided that suitable quantitative and qualitative disclosure is made in instances where this treatment is applied.

Cost-benefit considerations

In the Basis for Conclusions section of the ED it is noted that the decision to retain almost all of the IAS 39 requirements for the classification and measurement of financial liabilities was based on the Board's view that the benefits of changing practice did not outweigh the costs of disruption that such a change would cause.

While CEIOPS agrees with some of the consequences of this decision (for example, the retention of bifurcation requirements), it is not clear whether the Board has made this assessment of cost-benefit in the context solely of financial liabilities or in a wider context of the project to replace IAS 39. In CEIOPS' view, an assessment of cost-benefit must consider the proposals in their full context, i.e. how they interact with other parts of the IAS 39 replacement project, including IFRS 9, proposals on impairment and hedge accounting, and other related projects. This is particularly critical for insurance undertakings where considerable changes are also expected in respect of IFRS 4 Phase 2, increasing the impact of accounting change for firms and their supervisors.

Two-step approach

CEIOPS agrees that the portion of the fair value change that is attributable to changes in the credit risk of a liability should not be presented directly in profit or loss and supports the two-step approach. While we are concerned that this may increase the amount of detail present in the income statement, and could be perceived as increasing complexity or introducing new presentation methods, we are minded of the benefits that gross and net information provide. This approach should provide users with clearer information than would be available under a one-step approach, allowing a more straight-forward reconciliation of movements in the balance sheet with those detailed in the income statement.

However, an acceptable alternative would be a one-step approach where information about the total fair value change of the financial liability is required to be disclosed as part of the notes to the financial statements.

Presenting the effect of changes in a liability's credit risk in profit or loss

The Invitation to Comment section of the ED outlines an alternative approach in respect of potential accounting mismatches in profit or loss. This designation, as determined at initial recognition for an individual liability, would require an entity to present the changes in a liability's credit risk in profit or loss.

As noted above, in CEIOPS' view, the alternative approach may provide an acceptable treatment in rare instances where the own credit risk is reflected not only in the value of the liabilities but also in the value of related assets held by the undertaking. CEIOPS notes that the alternative approach introduces additional complexity and proposes to eliminate one inconsistency by introducing another, i.e. an accounting mismatch in profit or loss is replaced by creating an inconsistency in accounting for changes in own credit risk. However, these concerns might perhaps be addressed if the alternative approach was accompanied by appropriate disclosure in respect of its use – i.e. qualitative explanation of the rationale for applying the alternative approach in respect of an individual instrument or certain class or type of financial liability, and the quantum of changes in own credit risk retained in profit or loss that would otherwise have been recorded in OCI.

Embedded derivatives

CEIOPS agrees with the ED that bifurcation of embedded derivatives remains a useful and relevant accounting treatment for financial liabilities. However, CEIOPS finds that the continued existence of requirements for bifurcation of embedded derivatives is inconsistent with the treatment of embedded derivatives in financial asset contracts and limits the simplification for users of financial statements that IFRS 9 aims to deliver (arguably it may introduce more complexity through reducing symmetries of accounting). As a result, CEIOPS believes that this decision in respect of financial liabilities provides the Board with a useful opportunity to re-examine its decision on bifurcation in respect of financial assets, which in CEIOPS' view should be allowed as an option in some circumstances (as noted in CEIOPS response to the IASB Exposure DRAFT on "Financial Instruments: Classification and Measurement").

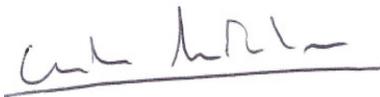
Timing of implementation

As previously expressed, we consider it important that insurance undertakings are not required to make fundamental changes to their financial reporting twice in close succession – once following the adoption of the IAS 39 review amendments and next following the adoption of IFRS 4 Phase 2. This would entail practical difficulties not just for the firms but also for supervisors who already rely on IFRS-based reporting for their solvency assessment and for whom each change to reported figures increases both the work required to be comfortable with reported figures and makes comparison more difficult.

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.

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

Best regards,

A handwritten signature in black ink, appearing to read 'Carlos Montalvo', is written over a horizontal line.

Carlos Montalvo
Secretary General

Appendix 1

This appendix sets out CEIOPS' responses to the specific questions raised in the ED.

Presenting the effects of changes in a liability's credit risk in profit or loss

Question 1

Do you agree that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss? If you disagree, why?

Question 2

Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit or loss unless such treatment would create a mismatch in profit or loss (in which case, the entire fair value change would be required to be presented in profit or loss)? Why?

CEIOPS' response to Questions 1 and 2

CEIOPS supports the IASB's proposal that changes in the credit risk of all liabilities designated under the fair value option should ordinarily not affect profit or loss.

In addition, in CEIOPS view it is important that the treatment of changes in own credit risk of all relevant financial liabilities (i.e. those designated to be measured under the fair value option) is consistent and comparable.

CEIOPS accepts that in certain circumstances – such as in rare instances where the own credit risk is reflected not only in the value of the liabilities but also in the value of related assets held by the undertaking - the alternative approach proposed may provide an acceptable treatment. CEIOPS notes that the scope for application of the alternative approach should be more clearly defined than expressed in the ED, which is currently based on the existence of a "mismatch in profit or loss" (ED, page 8).

However, CEIOPS also notes that this alternative approach introduces additional complexity and proposes to eliminate one inconsistency by introducing another, i.e. an accounting mismatch in profit or loss is replaced by creating an inconsistency in accounting for changes in own credit risk. CEIOPS notes that these concerns might perhaps be addressed if the alternative approach was accompanied by appropriate and sufficient disclosure in respect of its use. Appropriate disclosure might, for instance, include: qualitative explanation of the rationale for applying the alternative approach in respect of an individual instrument, certain class or type of financial liability and the corresponding 'matched' financial assets; qualitative disclosure of the quantum of changes in own credit risk retained in profit or loss that would otherwise have been recorded in OCI.

Presenting the effects of changes in a liability's credit risk in other comprehensive income

Question 3

Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?

CEIOPS' response to Question 3

In CEIOPS' view, the most preferable treatment of financial liabilities designated at fair value under the fair value option would be to record them on the balance sheet at a fair value that excludes changes relating to own credit risk (i.e. a 'frozen credit spread' approach). In the absence of such an approach, CEIOPS supports the proposals made in the ED that changes in credit risk be presented in other comprehensive income.

However, we also note that it is important that such changes are able to be recycled to profit or loss in the event that the instrument is derecognised to the extent that they form part of the overall gain or loss realised on derecognition.

Question 4

Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?

CEIOPS' response to Question 4

CEIOPS agrees that the two-step approach provides useful information. While this may increase the amount of detail present in the income statement, and could be perceived as increasing complexity or introducing new presentation methods, in our view this presentation provides users with clearer information than would be available under a one-step approach.

Question 5

Do you believe that the one-step approach is preferable to the two-step approach? If so, why?

CEIOPS' response to Question 5

As noted above, CEIOPS prefers the two-step approach. However, an acceptable alternative would be a one-step approach where information about the total fair value change of the financial liability is required to be disclosed as part of the notes to the financial statements.

Question 6

Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?

CEIOPS' response to Question 6

CEIOPS agrees with the IASB's observation in the Basis for Conclusions in paragraph BC34. Gains and losses arising from a liability's credit risk should affect an entity's performance, particularly when realised. CEIOPS is also minded that remeasurements of assets and liabilities should not be presented directly in equity because remeasurements meet the definition of gains (or losses) and are not transactions with equity holders.

Reclassifying amounts to profit or loss

Question 7

Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income (or included in equity if you responded 'yes' to Question 6) should not be reclassified to profit or loss? If not, why and in what circumstances should they be reclassified?

CEIOPS' response to Question 7

As noted previously, in CEIOPS' view gains or losses resulting from changes in a liability's credit risk included in other comprehensive income should be reclassified to profit or loss if the liability is derecognised.

CEIOPS encourages the IASB to reconsider the issue of recycling of realised gains and losses from other comprehensive income to profit or loss. In our view, this implies that the conceptual basis of the OCI has to be debated prior to deciding on its use.

Determining the effects of changes in a liability's credit risk

Question 8

For the purposes of the proposals in this exposure draft, do you agree that the guidance in IFRS 7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead and why?

CEIOPS' response to Question 8

CEIOPS agrees with the proposal to carry forward the IFRS 7 default method for determining the effects of changes in the credit risk. However, entities should only be permitted to use the IFRS 7 default method if it provides a faithful representation of the amount of the change in the fair value that is attributable to changes in the liability's credit risk.

Where neither the IFRS 7 default method nor an alternative method determined by the undertaking provide a faithful representation of the amount of the change in fair value that is attributable to changes in the liability's credit risk, CEIOPS considers that it is not appropriate to separate out such a change and would recommend that the entire change in fair value be recognised in profit or loss.

Effective date and transition

Question 9

Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?

CEIOPS' response to Question 9

CEIOPS agrees with the IASB's proposal to require that early adoption is only permitted where all preceding finalised phases have also been adopted.

However, CEIOPS is also minded to highlight the importance of the Board considering its progress on, and proposed implementation of, an insurance contracts standard. If the timing of the two projects does not coincide then this would entail practical difficulties not just for the firms but also for supervisors who already rely on IFRS-based reporting for their solvency assessment and for whom each change to reported figures provides considerable challenges.

Question 10

Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

CEIOPS' response to Question 10

CEIOPS agrees with the proposed transitional provisions to apply the requirements retrospectively.