

FÉDÉRATION FRANÇAISE DES SOCIÉTÉS D'ASSURANCES

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Paris, March, 30, 2010

LE PRÉSIDENT

Dear Madam,

EFRAG's Draft Comment Letter on the IASB's Exposure Draft "Financial Instruments: Amortised Cost and Impairment"

The Fédération Française des Sociétés d'Assurances (FFSA) welcomes the EFRAG's invitation for comments on their draft comment letter on the IASB's Exposure Draft "Financial Instruments: Classification and Measurement". The FFSA represents all types of insurance and reinsurance undertakings, accounting for 90% of the total French market.

The FFSA wishes to contribute to the on-going analysis made by the EFRAG on the ED and hopes its input will be useful in the process of finalizing the EFRAG's position.

The FFSA's overall position on the ED is close to the EFRAG's. In addition to the concerns raised by the EFRAG in their draft comment letter, the FFSA wishes to lay stress on the following issues that are crucial for insurance companies:

- debt securities portfolios
- practical expedients
- presentation and disclosure requirements

General support to the objective of amortised cost and concerns with operational challenges

As the EFRAG, the FFSA supports the principle of incorporating the expected losses in the amortized cost valuation to provide information on the effective return of a financial instrument, to the extent that this objective does not get confused with fair value measurement due to an inappropriate reflection of market fluctuations (refer to our answer to the ED's questions #1 & #2 in the appendix).

Mrs Kristy Robinson
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Further, as the EFRAG, the FFSA is concerned with the significant operational challenges, and corresponding costs, resulting from the definition of the overall principle of the expected cash flow approach and the methodology set in the ED (refer to our answer to the ED's question #3 in the appendix).

Debt securities portfolios

The FFSA is deeply concerned with the focus given to loan portfolios originated by banks and notes that the ED does not specifically address the case of debt securities portfolios, whereas specific issues apply to debt securities that differentiate them from bank loans as far as expected losses are concerned (refer to our answer to the ED's question #4 in the appendix).

Bonds portfolios account for the larger part of investments held by French insurance companies. These bonds consist mostly of high-quality bonds issued by OECD member states and, to a lesser extent, of investment grade corporate bonds.

Debt securities are usually listed and traded on an active market. This should not lead to an assessment of expected losses by reference to credit spreads reflected in market prices. Impairment criteria should remain entity-specific, with management using its own judgment. Consistently with the amortized cost principle based on an expected cash flow measurement, the expected losses under consideration should be those losses expected by the holder of the bonds, whatever prices are on the market. For instance, market data or ratings issued by rating agencies should only be used as potential indicators of future defaults. Similarly, spreads observed in the CDS market prices should not be used as a benchmark to value the credit risk of bonds which are held for collecting cash flows and not for trading. Market expectations of defaults - in bearish as well as in bullish markets, may introduce an undue bias in management's expectation of future cash flows.

Further, insignificant losses only were incurred in recent years on bond portfolios carried by French insurance companies. Recent studies show that the historical default rate observed on investment-grade bond portfolios is immaterial. Implementing a method as complex as the effective interest method in the ED to estimate immaterial expected losses would lead to undue costs without improving information provided to the users of the financial statements. Indeed, this method does not result in a better estimate of the frequency or the range of losses resulting from bond defaults. Issuers of financial statements should be allowed to use practical expedients adapted to their bond portfolios and information systems without the burden of having to demonstrate that the overall effect of using the practical expedient is immaterial.

We believe that an efficient expected loss model and a reliable amortised cost, in particular for bond portfolios, should be based only on historical data and statistics on past experience, excluding future possible scenarios.

Practical expedients

The FFSA concurs with the EFRAG in supporting the inclusion of practical expedients in the ED and in being concerned with the "materiality test" required to apply such practical expedients (refer to our answer to the ED's questions #11 & #12 in the appendix)

We believe that measurement principles in the exposure draft are already too prescriptive and read like methods rather than principles: they require applying the effective interest method; they require making estimates of the amounts and timing of cash flows; they require designing several future possible scenarios and assigning them a probability (refer to our answer to the ED's question #3 in the appendix).

Presentation and disclosure requirements

The FFSA fears that the information usefulness of the extensive presentation and disclosure requirements set in the ED would be impaired as the amount of default to be reported in the income statement and in the notes to the financial statements is likely to be immaterial on bonds portfolios (refer to our answer to the ED's question #5 in the appendix).

Detailed comments to the questions asked by the Board in their exposure draft are provided in the Appendix to this letter.

We hope you find these comments useful and would be pleased to provide any further information you might require.

Please contact Bertrand Labilloy at + 33 1 42 47 93 58 if you wish to discuss any of the issues raised.

Yours sincerely,

A handwritten signature in black ink, consisting of a large, stylized 'B' followed by a series of loops and a long horizontal stroke extending to the right.

Bernard Spitz

Detailed Answers to Questions Asked in the Board's Exposure Draft

Question 1

Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

We concur that the objective of amortised cost measurement as set out in the exposure draft is clear.

We note that the definition of amortised cost in the exposure draft departs from other definitions of the cost model currently existing in IFRSs, notably IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and obviously the current financial instruments standard, IAS 39: it shifts further away from the *recoverable historical cost* measurement basis and closer towards a *present value* measurement basis as defined under §100 of the Framework.

We deem it worth reminding that present value techniques are a subset of valuation techniques that can be used for fair value measurement purposes, as set forth in §38(b) of the 2009 *Fair Value Measurement* exposure draft. Therefore, we highlight the risk that the measurement objective of amortised cost in IFRS 9 gets confused with fair value measurement, especially when applied to financial instruments listed on a traded market such as bonds¹.

We would welcome mitigating the risk of misinterpretation through an enhanced precision of the measurement objective. As stated in the classification and measurement provisions of IFRS 9 *Financial Instruments*, assets at amortised cost are *held within a business model whose objective is to hold assets in order to collect contractual cash flows* [§4.2(a)]. Consistently, inputs used to measure amortised cost should be **entity-specific rather than market-based**, and amortised cost should reflect the **effective performance of the asset over its expected life rather than market fluctuations** that occur meanwhile.

Question 2

Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

We welcome the economic approach taken in the amortised cost measurement objective, whereby financial assets with higher yields also harbour higher risks and the cost of the risk should consequently be deducted from the asset's gross return from inception and all over the expected life of the asset. We welcome it insofar as it represents better information, both for the reporting entity and the financial statements reader, about the effective performance of the financial asset by avoiding inflated returns in early reporting periods that then turn to downgraded returns in later reporting periods, once credit losses are effectively incurred. It acknowledges that stability in performance reporting is relevant to assets held in order to collect cash flows, and that amortised cost is the appropriate model to reflect that stability.

Nevertheless, as detailed in our answer to question 4, we draw your attention to the necessity of having overall principles that are relevant and operational in their application to measuring bonds.

Question 3

¹ If market information is to be considered, conundrums such as the following arise:

- When market value of a listed instrument changes over the period while credit rating (hence the default risk) remains unchanged, should the amortised cost valuation of the instrument change (assuming the yield curve remains unchanged, for the sake of simplification)? Put otherwise, should amortised cost reflect the market valuation of credit risk?
- When both market value and credit rating of an instrument change, how to practically single out the portion of change attributable to the credit spread (vs. portions attributable to the interest rate spread and the liquidity spread)?

Do you agree with the way that the exposure draft is drafted, which emphasises measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why? How would you prefer the standard to be drafted instead, and why?

We believe that measurement principles in the exposure draft are already too prescriptive and read like methods rather than principles: they require applying the effective interest method; they require making estimates of the amounts and timing of cash flows; they require designing several future possible scenarios and assigning them a probability.

On such restrictive bases, the only benefit of any guidance would be to devise ways and means of improving the practicability of the methods proposed.

For that reason, we welcome the possibility provided in the application guidance (§B4 to B6) to estimate the effect of credit losses on expected cash flows on a collective basis, since a line-by-line approach would make the method impracticable². We are however concerned that the application of a collective approach is so much constrained by the measurement methods that little benefit can be expected of it in the end: the effective interest rate method will require that financial assets be pooled on the basis of homogeneous credit standings and contractual interest rates; the estimation of the timing of cash flows will require that assets be pooled on the basis of homogeneous origination dates and similar maturities, as well. Even when approached on a collective basis, financial assets will hence have to be broken down into multiple buckets that entities will have little room to adapt to the way they actually pool and manage those assets. Furthermore, we understand that each of these multiple buckets will have to be disclosed in separate schedules showing changes from one period to the next and from one bucket to another together with explanations for these changes.

We do not believe that §B17 is of any help in terms of guidance for practical expedients. That paragraph states that a practical expedient may be allowed only if the difference in outcomes with the standard method is immaterial. This would result in applying both methods to evidence the immaterial difference, putting a double burden on the reporting entity and denying that the need for a practical expedient results precisely from the impracticability of applying the standard method.

To conclude, we believe that the measurement method should be simplified. We therefore welcome the setting up of the Expert Advisory Panel that is to contribute to crafting practical expedients. But we raise some concerns in that respect: the prescriptive requirements in the exposure draft will leave little room for simplification to the Panel.

Question 4

(a) Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?

As (re)insurers, our answer is focused on a specific class of financial assets, namely bonds.

We first wish to highlight that investment grade bond portfolios, as those commonly held by (re)insurers as a result of prudential regulation and ALM practices, suffer from very low default rates historically. A public study by Standard & Poor's, *Default, Transition, and Recovery: 2008 Annual Global Corporate Default Study And Rating Transitions*, shows that investment grade defaults have remained well below 0,5% over more than 25 years, even through recessions and even though only corporate issues are considered in the study (Chart 1, page 3 of the study; Table 2, pages 3-4).

² Managing expected cash flows on a line-by-line basis (i.e. a sequence of expected cash flows for every financial asset) would necessitate IT systems that are not currently implemented and generate disproportionate operational costs. Consequently, the method seems reasonable only if applied to large groups of financial assets.

The table below reaches the same conclusion. It shows data collected from seven French insurers representing 48% of the French insurance market. Default rates in bond portfolios held by insurers reach 0.1% in worst years.

Default rate – sovereign and corporate	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
End-of-year amount of bonds held (€m) (A)	75 569,16	84 953,39	149 497,05	165 865,82	257 377,47	282 160,92	317 067,00	347 090,42	367 480,12	388 887,43
Total amount of defaults over the year (€m) (B)	1,10	0,33	0,45	1,69	1,68	0,44	0,41	0,40	345,09	176,18
Ratio of defaults by year (B)/(A)	0,00146%	0,00039%	0,00030%	0,00102%	0,00065%	0,00016%	0,00013%	0,00012%	0,09391%	0,04530%

Even when excluding sovereign issues and considering corporate issues only, as in the S&P study, default rates remain immaterial, below 0,2%.

Default rate – corporate issues	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
End-of-year amount of bonds held (€m) (A)	37 671,65	39 705,15	51 915,23	56 947,88	100 552,95	111 399,17	135 429,22	159 144,28	175 774,11	198 161,83
Total amount of defaults over the year (€m) (B)	0,65	0,00	0,00	1,24	1,24	0,00	0,00	0,00	344,76	176,14
Ratio of defaults by year (B)/(A)	0,00173%	0,00000%	0,00000%	0,00218%	0,00123%	0,00000%	0,00000%	0,00000%	0,19614%	0,08888%

Consequently, our first point is that **it makes little sense to implement as complex a method as the effective interest method to estimate such an immaterial portion of investment grade bond portfolios as the credit risk.**

Secondly, we note that the S&P study illustrates how infrequently an investment grade default occurs (Table 4 on pages 8-9³). Table 5 of the S&P study also reminds of the largest global rated defaults by year from 1991 to 2008 and shows that large defaults are very rare and cannot be anticipated, as illustrated with Lehman Brothers Holdings Inc. in 2008.

As a consequence and as far as investment grade bond portfolios are concerned, we deem that **a method based on probability-weighted possible outcomes as proposed in the exposure draft gives the false impression that losses are approached in a finer and more sophisticated way, while it does no better at anticipating the frequency or the range of losses** resulting from bond defaults than the current incurred loss model. It would remain far from providing better financial information on the performance of a bond portfolio. We find no ground for implementing a complex method if it does not produce more relevant information for the financial statement readers.

For that reason, we propose **excluding future possible scenarios** from the method and **using historical data and statistics.**

Furthermore, we deem worth emphasizing another danger of a forward-looking estimation of future credit losses. Indeed, market expectations would bias management assessment of future losses and would set over-expectations of future cash flows in bullish markets and under-estimate future cash flows in bearish ones. Such biases would provide neither relevant nor reliable information for the financial statement readers.

Consistently with the amortized cost principle based on an expected cash flow measurement, the expected losses under consideration should be those losses expected by the holder of the bonds based on historical data, whatever prices are on the bond or the CDS market. Impairment criteria should remain entity-specific, with management using its own judgment. As stated in BC 15, impairment loss on a financial instrument carried at amortized cost should not be based on fair value of the instrument. Market data as well as ratings issued by rating agencies should only be used as potential indicators of future defaults.

(b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?

Given the immateriality of investment grade bond defaults historically as well as the proven impossibility to predict the timing of those defaults, as a practical expedient, we propose relying on past experience and applying an average historical rate of default to the gross amount of bond portfolios at the end of each reporting period.

³ from 1981 to 2008, the yearly number of investment grade companies defaulting globally reached double digits in 2002 and 2008 only; of the 28 years considered, nine were free of any default, including 2006 and 2007.

Question 5

(a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?

We deem the objective clear. We wonder whether it is not too far-reaching, hence irrelevant, in regard of amounts at stake as far as investment grade bond portfolios are concerned.

(b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

In relation with the first part of our answer to Question 4(a), we believe there is little ground for providing five line items in the statement of comprehensive income as well as extensive explanations to account for less than 0.5% of the bond portfolio itself.

Given the immateriality of credit loss figures, we believe that providing net interest revenue as a single line item is the only relevant piece of information to be shown on the face of the statement of comprehensive income. Additional disclosure may include the expected default rate applied to the bond portfolio at each reporting date, an explanation about the variance in the default rate applied from period to period, and historical data about default rates actually incurred similar to that produced in answer to Question 4(a).

Question 6

Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

We identified many items that would flow to the statement of comprehensive income in application of the method proposed in the exposure draft and that will vary from period to period:

- Accretion expenses (i.e. the unwinding of discounts applied to compute the present value of expected cash flows) stemming both from the portion of initial expected credit losses and from gains and losses resulting from changes in estimates;
- Gains and losses resulting from changes in credit loss estimates, which would include both a catch-up of past estimates booked in prior periods and a revision of future estimates;
- Variances between forward rates initially expected and spot rates actually experienced, when dealing with a variable rate financial asset.

These variances are intricately mixed: they can be measured all together, but any separate measurement would only be a judgemental allocation of the total amount. Therefore, we believe that implementing the proposed presentation beyond the simple examples accompanying the exposure draft would be very challenging, and even more so when it comes to explaining and rationalising variances of the figures from period to period.

Question 7

(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?

As discussed in our answer to Question 5(b), we see little added value for the financial statement readers in extensive disclosures relating to a mere 0.5% of financial assets at stake.

Further, as mentioned in our answer to Question 3, we are concerned that the complexity and volume of disclosure requirements will confuse users of financial reporting and detract from the value and clarity of the financial statements.

Question 8

Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

In connection with IFRS 9 *Financial Instruments - Classification and Measurement*, (re)insurers have already expressed concerns about the mandatory application date of revisions to IAS 39 with respect to the first application date of the coming *Insurance Contracts* standard. If the asset and liability matching performance of (re)insurers is to be truly reflected in their financial statements, appropriate accounting methods for financial assets and for insurance obligations should be selected in parallel. This would be possible only:

- if the mandatory application date for the proposed revisions is no sooner than the first application date of the standard that is to replace the current IFRS 4,
- and if (re)insurers who chose to early-adopt revisions to IAS 39 are allowed to reconsider their selection of accounting methods for financial assets when they transition to the standard that is to replace the current IFRS 4.

Question 9

(a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?

(b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?

(c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.

With regard to bond portfolios held by (re)insurers, we consider that the complex measurement method proposed in the exposure draft is inappropriate, as explained in our answers to previous questions. Consistently, we consider that the ensuing complex transition requirements are inappropriate.

Restatement of comparative information would be practical, sensible and relevant if performed on the basis of the alternative method that we propose in our answer to Question 4(b).

Question 10

Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

Application of §28 of the exposure draft would be practical, sensible and relevant if performed on the basis of the alternative method that we propose in our answer to Question 4(b).

Question 11

Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

Please refer to our answer to Question 3 as a first step to addressing the above question.

Our answer to Question 4(b) proposes an alternative method that might be considered as an effective practical expedient for investment grade bond portfolios, such as those commonly held by (re)insurers.

We consider that the materiality condition set in appendix B15 for an issuer of financial statements to use practical expedients is not appropriate as it would require performing both calculations to demonstrate that the overall effect of using the practical expedient is immaterial.

Question 12

Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

Consistently with our answers to previous questions, we consider that estimation of future possible outcomes for cash flows that cannot reasonably be predicted would lead to no better information than the current incurred loss model. Indeed, we expect that the Expert Advisory Panel will demonstrate that expected losses based on future possible scenarios will lead to nothing else but accounting for incurred losses, by lack of visibility into the future.

Therefore we do not believe that practical expedients should seek approximating the outcome that would result from the proposed requirements. We believe that an efficient expected loss model and a reliable amortised cost should be based on historical data and past experience.