Investments

Effects of changes in value of equities and equity-based derivatives

Strict application of IFRS accounting principles

Equity-based derivatives (held for trading)	Equities (available for sale)
All changes in value are **recognised on income statement**	All changes in value are recognised in shareholders' equity, **no effect on profit or loss**

General IFRS accounting regulations therefore lead to mismatch on income statement

Special Case 1: Fair value hedge accounting under IFRS

- ***Preconditions for fair value hedging:*** ***(in acc. with IAS 39.88)***
  - Formal documentation of hedging relationship
  - Highly effective hedging relationship
  - Reliable measurability of effectiveness
  - Proof of effectiveness at every balance sheet date
- ***Consequence:*** All fluctuations in value – including those of underlying equities – are **recognised on income statement**, mirroring the changes in value of derivatives
  - In case of **rising** share prices: Write-off of derivative and write-up of shares
  - In case of **falling** share prices: Write-up of derivative and write-off of shares

Strong price changes lead to inflated income and expenses (no netting)

Investments

Effects of changes in value of equities and equity-based derivatives (contd.)

Special Case 2: Write-down of shares owing to significant or sustained impairment

- Shares are considered to be subject to impairment if fair value falls below average historical acquisition price *significantly (20%)* or *for a sustained period (6 months)*. In this case, the unrealised loss recognised in equity is reversed and **recognised as expense** in income statement.
- **Important**: *Further declines* in share prices already written down in past are recognised immediately in the income statement ("once impaired, always impaired").
- By contrast, recoveries in value are always recognised in equity **with no effect on profit or loss**. There is no limitation on write-ups under fair-value measurement.

Conclusion:

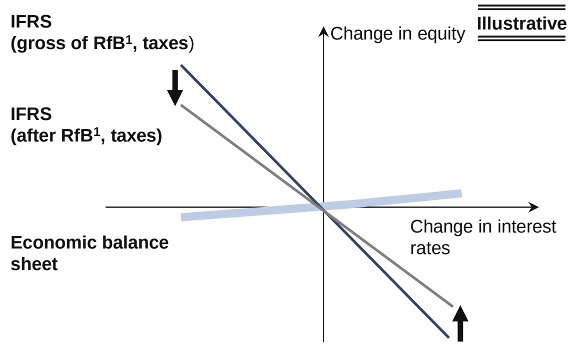
- Changes in value of shares/derivatives are not reflected in a uniform manner on the balance sheet and income statement, and they depend on the extent of underlying hedging relationships.

→ ***In very volatile capital markets, it is more difficult to predict the effects on profit and loss where there is no hedge accounting.***

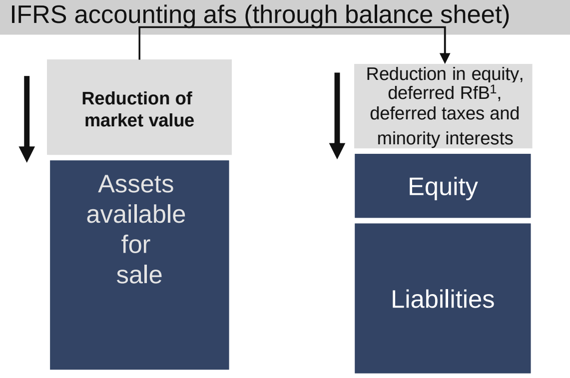
Economic vs. accounting view

"Accounting mismatch"

Accounting mismatch



IFRS accounting afs (through balance sheet)



Economic perspective

- Fair values of investments and provisions with equal duration develop parallel
- Primary L&H: Slight increase in economic equity in case of rising interest rates due to longer duration of provisions

View according to IFRS accounting

- Valuation of investments mainly at market values while large proportion of covered provisions is valued at undiscounted best estimate
- Valuation mismatch of assets and liabilities leads to volatility of shareholders' equity
- Primary L&H: Participation of policyholders in unrealised gains and losses through RfB[1] and deferred taxes has mitigating effect

[1] RfB: Reserve for premium refunds (Rückstellungen für Beitragsrückerstattungen).