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Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street

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Berlin, 8 October 2004

Dear Sir David

ED amendments to IAS 39 and IFRS 4, Financial Guarantee Contracts and Credit Insurance

We appreciate the opportunity to comment on the Exposure Draft of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts, Financial Guarantee Contracts and Credit Insurance.

As we have set out in our comment letter on ED 5 *Insurance Contracts*, dated 12 November 2003, we welcome that insurance against credit risk was included in the scope of the current definition of insurance contracts according to ED 5/ IFRS 4. Whilst we principally support the current requirements that credit insurance contracts are within the scope of IFRS 4, whereas financial guarantees are treated in accordance with IAS 39 and IAS 37, we do not see the need for issuing the present Exposure Draft.
When developing IFRS 4, the Board stated clearly that the objective of Phase I of the insurance project was to make limited improvements while avoiding major changes until finalising Phase II. Insofar, we regard any changes for credit insurance contracts as inappropriate as long as the accounting treatment of insurance contracts in general is still under consideration. Particularly, since most of the arguments set out in this Exposure Draft have already been considered when finalising IFRS 4, we wonder why the Board intends to reverse its decision on credit insurance contracts shortly after publishing IFRS 4.

Moreover, we see important differences in the economic substance arising from a different business model rather than differences in legal form. The insurance business model is based on a portfolio approach, which means pooling the individual insurance risks within the portfolio and over time. As the insured event is fortuitous, estimating the future cash flows from an insurance contract is a stochastic process. This business model also applies for insurance against credit risk. The portfolio approach and the stochastic process are key characteristics of insurance business, whose appropriate reflection in the financial statements will be one of the main issues to be discussed in Phase II of the insurance project. Thus, we do not support changing the accounting treatment of credit insurance contracts at that time, since the reflection of the underlying business will be subject of Phase II. Insofar, we regard the discussion on credit insurance contracts as premature in this phase and believe a consistent treatment of various insurance activities being more important than a consistent treatment of financial guarantees and credit insurance contracts.

Apart from our arguments in support of a different accounting treatment, we do not see how the current IAS 37 can provide a consistent accounting treatment. As IAS 37 allows the individual valuation as well as a portfolio valuation, in contrast to the intended, financial guarantees and credit insurance contracts are not measured consistently. Since the intention of a consistent accounting treatment will not be met with the proposed requirements, we do not understand at all the Board's decision of re-excluding credit insurance contracts from the scope of IFRS 4. We are of the opinion that all credit insurance contracts and financial guarantees that meet the definition of an insurance contract should be within the scope of IFRS 4. Financial guarantees, which were recognised previously under IAS 39, are allowed to be accounted for in the same way under IFRS 4 in Phase I. We would however regard it as essential reconsidering this issue in Phase II when finalising a new comprehensive standard on insurance contracts.

Concerns could have been raised that a guarantor or credit insurer may not recognise a liability under IFRS 4 when issuing a financial guarantee or credit insurance contract. Since IFRS 4 requires the application of a liability adequacy test, we do not share these concerns.

Due to our arguments set out in this comment letter, we do not agree with the Exposure Draft at all. Please find in the Appendix our more detailed comments in answer to the questions.

If you would like any clarification of these comments, please contact me.

Yours sincerely,

Prof. Dr. Klaus Pohle
President

Appendix

Question 1 – Form of Contract:

The Exposure Draft deals with contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment when due under the original or modified terms of a debt instrument (financial guarantee contracts). These contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. Under the proposals in the Exposure Draft the legal form of such contracts would not affect their accounting treatment (see paragraphs BC2 and BC3).

Do you agree that the legal form of such contracts should not affect their accounting treatment?

If not, what differences in legal form justify differences in accounting treatments? Please be specific about the nature of the differences and explain clearly how they influence the selection of appropriate accounting requirements.

GASB's comment:

As set out above, we explicitly supported in our comment letter on ED 5 the inclusion of credit insurance contracts in the scope of ED5/IFRS 4. Whilst we are still of the opinion that there are differences between credit insurance contracts and financial guarantees, which justify a different accounting treatment, we regard focussing on the legal form as irrelevant. The differences in legal form result in differences in the economic substance, which necessitate a different risk management. A major difference between a credit insurance contract and a financial guarantee is the contractual partner of the issuer. A financial guarantee such as a bank guarantee or letter of credit is usually arranged on request of the party whose obligation is to be guaranteed. Such a guarantee is a contract between the issuer of the guarantee and a debtor ensuring that a certain liability is met if the debtor fails to settle his debt. In the case that the debtor fails, the guarantor usually has to pay on the first notice on default irrespective of whether the default was fortuitous or subject to moral hazard. Although the issuer may have a claim for recourse against the debtor, a case of moral hazard does not influence the issuer's obligation for payment.

In contrast, insurance against credit risk is arranged by a supplier and protects the supplier against default by the customer. The fact that the default of the customer is outside of the supplier's control allows the insurer using stochastic

methods to estimate future cash flows from the contract, because they are at random and not subject to moral hazard. Furthermore, the credit insurer may refuse to pay a claim if the policyholder did not give full disclosure that the contractual conditions are met and may delay payment while a claim is investigated.
Another major difference is in the range of services offered by credit insurers. Aside the reimbursement, credit insurance contracts often contain additional services such as dunning procedures or encashment, whereas financial guarantees offer solely the guarantee of the debt. Therefore, the features of credit insurance are not traded in active markets, as it may be the case for financial instruments related with credit risks.

These differences give reason to a different economic consideration. A guarantor verifies the creditworthiness and other important factors of each requesting debtor in order to estimate the risk of every single contract. Insurance against credit risk is focussing on a portfolio in the same way as other insurance activities. In consideration of the condition of ‘substance over form’, we believe therefore that the differences in economic substance justify a different accounting treatment for credit insurance contracts and for (other) financial guarantees. As the future cash flows arising from credit insurance contracts are at random and the risk is managed by pooling individual risk in a portfolio of credit insurance contracts, the issuer of such contracts is able to use stochastic methods to measure the expected value of his liability, which is subject to the probability of loss or damage in the portfolio. Whilst the assumption of credit risk by a credit insurer is a stochastic process, the risk within a financial guarantee depends on the individual creditworthiness of the debtor (holder of the guarantee), which is checked by the issuer before contracting. Thus, the guarantor’s obligation from a guarantee arises just in the moment of a certain individual debtor’s default. Stochastic or actuarial methods are irrelevant for measuring such financial guarantees.

Against the background of the differences in economic substance between credit insurance contracts and (other) financial guarantees, we strongly support the application of IFRS 4 on credit insurance contracts. We would also like to refer back again to our response to question 2 in the comment letter on ED 5. Since the Board set out in paragraph B18 in the amendments to IFRS 4 in this ED, that credit insurance contracts meet the definition of insurance contracts if they transfer significant insurance risk, we regard the conclusion that such contracts also meet the definition of a financial guarantee and should therefore be within the scope of IAS 32 and 39 as highly inconsistent.

Question 2 – Scope

The Exposure Draft proposes that all financial guarantee contracts should be within the scope of IAS 39 (see paragraph 2 of IAS 39 and paragraph 4 of IFRS 4), and defines a financial guarantee contract as "contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument" (see paragraph 9 of IAS 39).

Is it the proposed scope appropriate?

If not, what changes do you propose, and why?

GASB's comment:

The definition of a financial guarantee as set out in IAS 39 is strongly influenced by the definition of insurance contracts in IFRS 4. The definition requires the issuer to reimburse the holder for a loss arising from a specified debtors default. This actually includes that the holder of a credit insurance contract is the creditor, whereas the holder of the guarantee is the debtor who is not the contracting party being reimbursed for a loss. We do not believe the definition being appropriate. As we have set out in our answer to question 1, it is the business model rather than the legal form that makes the difference between financial guarantees and credit insurance contracts. Particularly with regard to the Board's statement that credit insurance contracts meet the definition of insurance contracts, we do not understand the arguments for an exclusion from the scope of IFRS 4. Referring to our arguments above, we recommend reviewing the definition of insurance contracts in Phase II because the business model, which means managing insurance risk on a portfolio basis, has been unconsidered in the definition according to IFRS 4. We would like to assure again our fully committed cooperation in developing a long-term solution.

Question 3 – Subsequent measurement

The Exposure Draft proposes that financial guarantee contracts, other than those that were entered into or retained on transferring financial assets or financial liabilities within the scope of IAS 39 to another party, should be measured subsequently at the higher of:

(a) the amount recognised in accordance with IAS 37 *Provisions, Contingent Liabilities* *and Contingent Assets*, and

(b) the amount initially recognised (ie fair value) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue* (see paragraph 47(c) of IAS 39).

Is this proposal appropriate? If not, what changes do you propose, and why?

GASB's comment:

Against the background that the objective of the ED is to provide the same accounting treatment for financial guarantees and credit insurance contracts, we have identified the following problems regarding the subsequent measurement. The ED proposes that financial guarantees and credit insurance contracts are measured subsequently in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* at the amount an entity would rationally be expected to pay in order to settle the obligation from the guarantee. Whilst the application of IAS 37 could result in a subsequent measurement at nil if the probability threshold in IAS 37 was not met, the Board decided to require the issuer to recognise the higher of the amount according to IAS 37 and the amount initially recognised less amortisation in accordance with IAS 18.

Whilst we understand the concerns that financial guarantees would be measured at nil immediately after the initial recognition because the obligation is not probable according to IAS 37, we are of the opinion that this is a problem within IAS 37 relating to all contingent liabilities rather than particularly to financial guarantees. In contrast, for a credit insurance contract under IFRS 4 the probability threshold would be irrelevant. This holds true particularly due to the stochastic measurement model of insurance business, which considers the probability of loss occurring in the expected value by weighting the future cash flows. In addition, the issuer of an insurance contract is required according to IFRS 4 to assess at each reporting date whether its recognised insurance liabilities are adequate, using current estimates of future cash flows (liability adequacy test). Thus, we believe that the Exposure Draft does not provide a consistent measurement of financial guarantees and credit insurance contracts.

Furthermore, it is not clear to us whether the reference to IAS 18 just means the application of paragraphs 20 – 28 of IAS 18. Since paragraph 31 of IAS 18 has been deleted, the term 'amortisation' could be misleading in this context. We therefore suggest expressing more clearly, what exactly is meant by the reference to IAS 18 and how premiums should be measured and amortised according to this Exposure Draft.

Regarding the reference to FIN 45, we are concerned that the concept according to FIN 45 could diverge from the fair value measurement model of IAS 39. While the separate recognition of the premiums on the one side and the liability on the other side is current accounting practice for credit insurance contracts, financial guarantee contracts are usually recognised and measured as a whole. As neither FIN 45 nor this Exposure Draft contains detailed requirements, we suggest providing more guidance on the fair value measurement of financial guarantees.

The ED proposes that the issuer of a financial guarantee or a credit insurance contract is required to measure the contract initially at fair value and that the fair value in the case of a stand-alone arm's length transaction to an unrelated party is likely to equal the premium received. Although the proposal says 'premium received' we are not sure if that means 'received' or 'receivable'. The fair value of a premium 'received' will be nil, because the present value of the premiums is usually equal to the present value of the future obligation. In contrast, 'receivable' would mean recognising all premiums receivable over the contract term. In the latter case, we see some difficulties defining the relevant discount rate. This question came up because the Exposure Draft refers to FIN 45, which says "…premiums received or receivable". We suggest providing clarification on this matter.

In view of our arguments discussed above, we are concerned that the proposals of this ED will not lead to a relevant and reliable accounting treatment for financial guarantees and credit insurance contracts. We therefore suggest that credit insurance contracts should remain within the scope of IFRS 4.

Question 4 – Effective date and transition

The proposals would apply to periods beginning on or after 1 January 2006, with earlier application encouraged (see paragraph BC27). The proposals would be applied retrospectively.

Are the proposed effective date and transition appropriate? If not, what changes do you propose, and why?

GASB's comment:

If the Board decides to retain the proposed accounting treatment of financial guarantees and credit insurance contracts, we agree with the proposed effective date and transition. However, we would like to refer back to our concerns set out in this comment letter.

Question 5 – Other comments

Do you have any other comments on the proposals?

GASB's comment:

No.