ICISA
INTERNATIONAL CREDIT
INSURANCE & SURETY
ASSOCIATION

CL 37A

Sir David Tweedie
Chairman
International Accounting Standards Board
30, Cannon Street, London EC4M 6XH,
United Kingdom

4 September 2002

Dear Sir David,

This letter is submitted on behalf of the members of the International Credit Insurance and Surety Association (ICISA).

ICISA has represented the credit insurance and surety industry since 1928. Its members annually insure trade credit in excess of US$ 1,000 billion. Members include the three largest global credit insurance groups, Euler & Hermes, Gerling NCM and the Coface Group. Surety member include groups like the Chubb corporation and Travelers. Specialist reinsurers like Munich Re, Swiss Re and GE Frankona are also members of the association. In Annex 1 you will find a full list of our members.

We fully support the Board's objective of improving accounting standards worldwide and appreciate the efforts made to address more particularly the specifics of credit insurance and surety bond contracts.
We would, however, like to make a few important remarks, which may be summarised as follows:

- the definition for “financial guarantees” should not include credit insurance contracts;
- Credit insurance products are intrinsically different form products and services provided by banks, and should be recognised as such;
- Credit insurance contracts are not traded on capital markets, contrary to the stated assumption;
- Credit insurance risks are managed in an entirely different manner than bank credit risks;

- Credit insurance contracts are insurance contracts, and should fall under the DSOP of insurance contracts;
- In the current situation, credit insurers need to apply IAS 39 at inception, and IAS 37 subsequently. The may lead to practical difficulties;
- IAS 37 does not contain specific guidance with regard to appropriate rules for measuring credit insurance contracts.

This letter is aimed at providing the International Accounting Standards Board with comments regarding the current status of credit insurance contracts in the International Accounting Standards in the Draft Statement of Principles on Insurance contracts (DSOP) and in the proposed amendments to IAS 32 and IAS 39.

Credit insurance and surety contracts in the International Accounting Standards:

Credit insurance insures manufacturers and traders against the risk that their buyer does not pay. It can also cover the risk that a buyer pays very late. A buyer will not pay after he has been declared bankrupt, insolvent, or a similar legal framework, depending on the country where the buyer is based. Similarly buyers sometimes opt for a bankruptcy protection arrangement, which allows them to delay payments for an extended period. Credit insurance policies can include a wider range of cover, depending on the circumstances.

Surety bonds are normally required under the terms of a construction or engineering contract, or in accordance with mandatory legal requirements, to secure the obligations of the principal debtor (generally known to the principal).
A surety bond provides the security to protect the creditor against the default or insolvency of the principal up to the limit of the bond. For example, the failure of a contractor to complete a contract in accordance with its terms and specifications or the failure of an enterprise to pay taxes or customs duties to a government or department.

All credit insurance and surety companies have the status of insurance companies and are committed to the corresponding requirements with regard to financial information in their respective country.
The traditional client of a credit insurer is a small or medium sized company that trades domestically and/or exports. Credit insurance is often required by financing banks, as an added security for the payment of trade receivables of that client. In these cases, rights under the policies are often assigned to that bank.

In the DSOP on insurance contracts, credit insurance contracts are deemed similar to financial guarantees and explicitly excluded from the scope of the standard. The proposed amendments of IAS 32 and IAS 39 state that financial guarantee contracts should be initially recognised and measured in accordance with IAS 39 and, subsequently according to the IAS 37, with the objective that "*financial guarantee contracts that provide for specified payments to be made to reimburse the holder for a* *loss it incurs because a specified debtor fails to make payment when due are recognized as liabilities".*

We believe that the definition of financial guarantees provided cannot be adapted to the specifics of credit insurance contracts. The risk under a credit insurance contract is less than the sum of all individual risks insured under that contract. Furthermore, the contract also provides additional services to assist the policyholder in his trade.

We believe that the standards in their current status do not properly address the specifics of credit insurance contracts and that, in this particular case, they may lead to discrepancies, which would be in contradiction to the IASC's objectives.

We encourage the Board to consider our proposal that credit insurance contracts should be recognized as insurance contracts and subsequently fall under the DSOP on insurance contracts. We are strongly convinced that the Board should not fear that bank products would fall under the insurance contract norm as credit insurance contracts are intrinsically different from the products and services banks offer in the field of credit risk. We also believe that the most consistent way to ensure that all liabilities arising from credit insurance contracts are recognized, is to include these contracts in the scope of the DSOP on insurance contracts as it will allow appropriate measurement guidance on insurance contracts and allow a consistent approach between the policyholder, the direct insurer and its reinsurers.

Exclusion from the DSOP on insurance contracts

Credit insurance and surety contracts have all the characteristics of insurance contracts as defined in the DSOP (*"an insurance contract is a contract under which one party accepts an insurance risk by agreeing with another party to compensate the policyholder if a specified uncertain future event adversely affects the policyholder …"*) whereas they don't meet the definition of a financial risk ("*a risk of a possible future in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable*").

We believe the rationale used to exclude credit insurance contracts from the scope of the DSOP on insurance contracts relies upon an incorrect understanding of the specifics of the credit insurance contract:

- credit risks written through credit insurance contracts are not commonly traded in capital markets
- the way credit insurance contracts issuers control the credit risk is very different from the way banks manage credit risk in a portfolio of financial guarantees,

- "*credit risk is a risk commonly traded on capital markets*"

Credit insurance contracts have never been traded as such in capital markets, unlike contracts with credit derivatives or similar banking products. Credit risk can indeed be traded, but only on a single buyer basis on behalf of large suppliers.

The credit insurer does not normally offer single risk cover, but whole turnover policies, which cover the total of the receivables portfolio of its clients. As such, each credit insurance contract bears a statistical insurance risk that is not traded in the capital markets. Moreover, by insuring the whole portfolio of receivables without exemptions, the great majority of the credit insurers risks are on small and medium sized companies which are not known to the capital markets and on which credit guarantees are not traded in capital markets.

- "*the way credit insurers manage credit risk is no different from the way banks manage credit risk in a portfolio of financial guarantees*"

The way credit insurers manage credit risk is indeed very different from the way banks manage credit risk. In our view, the main differences are the following:

- while banks manage their risk on a single risk basis, credit insurers offer global coverage over a specified period with revolving amounts covered, as well as discretionary limits up to agreed amounts under which they do not even know the names on which they assess risk (which is then purely a statistical risk).

- at the inception date of the insurance contract, the issuer of the contract does not know the number and the amount of the transactions he will cover. As such, on top of the credit risk, the insurer bears an occurrence and a severity risk during the whole length of the policy

- while banks generally write a risk and await the completion of the transaction, credit insurers manage their risks daily on a case by case basis and have the contractual ability to reduce their exposures and withdraw from the risks on existing contracts without any changes in the prices of the service offered.

- while banks generally know the amount of the risks they cover on a single transaction, the credit insurer does not know his exact exposure until a claim is registered. Cover is provided as a revolving insured amount, but usage is uncertain.

- in order to limit moral hazard, credit insurance contracts always specify a retention of the risk kept by the policyholder whereas banks generally reimburse their customers in full.

- banks usually issue abstract guarantees, whereby the compliance with written requirements, like a letter of credit, leads to a successful transaction. Credit insurers rely on the actual delivery of goods and/or services to take place between the insured (supplier) and his buyer. Only the fulfilment of that underlying contract can lead to a successful transaction according to the policy.

- banks can provide unconditional on demand guarantees, while credit insurance and surety contracts are always conditional.

- US GAAP recognises the conditionality of surety contracts. It is not desirable that IAS deviates from this approach.

Assimilation of credit insurance to financial guarantees

The Joint Working Group Draft defined a financial guarantee as "*a contract that requires payments to be made to a creditor if a specified debtor fails to make payments when due*". Although, as a general definition, this is of course the case for credit insurance contracts, we believe this definition gives only a restrictive view of the reality of a credit insurance contract:

- Credit insurance contracts generally contain conditions under which payments may be made to the policyholder without any reference to credit risk, for instance through profit sharing agreements.

- The conditionality is either linked to the obligations set on the policyholder or related to the credit insurer's agreement of the specified risk prior to each individual transaction. Conditions may even be set on the policy as a whole (such as maximum loss clauses) without any reference to a specified debtor. There is a number of particular cases where a credit insurance contract does not require payments to be made to the creditor even if the debtor failed to make payments when due.

- Almost all credit insurance contracts do not provide any specific guarantee on specific debtors, but are rather the right for the insured to benefit, during the life of the policy, from potential cover on all his current and future debtors, as well as related services (credit limits, information, ratings, collections). In other words, the credit insurance contract is not only a contractual right to receive cash, but also a contractual right and the insurance to benefit from a service during a certain period of time.

- Credit insurance deals exclusively with trade receivable debts. Reinsurers explicitly exclude financial guarantees, as issued by banks, from their reinsurance contracts with insurers.

In conclusion, our view is that credit insurance contracts are far more complex than a single financial guarantee as defined in the current standards and should not be seen as the sum of each individual guarantee on which the credit insurer might have granted cover during the life of the policy. If IAS 39 is certainly applicable to each single guarantee, we believe it is not applicable to the credit insurance contract as a whole, which is more an "inter-company trade assistance" product than a single financial guarantee.

Practical difficulty to apply two different standards

We believe the current proposal, which consists as we understand it, in applying IAS 39 at initial recognition and subsequently IAS 37, does not provide sufficient guidance and may lead to practical implementation difficulties.

In the current standards, it is not clear whether the initial recognition should be required each time a single credit risk is written, that is on a "transaction by transaction" basis, or whether initial recognition should only apply at the date the insurance contract is written. We understand that, either the credit insurance contract is recognized as a contract as a whole measured in itself, or it is considered as a collection of individual credit risk assessments, independent from one another. In the first case, we believe that, measuring the credit insurance contract in itself at inception date, is equivalent to stating that its value is different from the sum of the individual values of the risks that may be underwritten. The difference between these two values would in our view be the measurement of the insurance risk. In the second case, we fear that such concepts will be practically impossible to implement, as it is virtually impossible to measure (and even identify) each single insured transaction.

The use of two different standards between initial recognition and subsequent measurements may lead to practical difficulties like evaluation differences.

Some complications may arise as IAS 37 does not provide sufficient guidance to allow appropriate rules for measurement of insurance contracts, especially regarding revenues and margins. For instance, IAS 37 requires that recoveries be recorded if they are virtually certain. It means that it is unlikely that future salvages could be recognised as assets in the IAS 37 whereas IAS 39 and the DSOP on insurance contracts would allow their recognition (either at fair or entity specific value).

It is still very difficult for us to identify precisely what would be the exact implications of the proposed treatment for credit insurance and surety contracts, be it for the policyholder, the insurer itself or its reinsurers. We fear the proposed solution raises technical and practical questions which may lead to significant differences in interpretation, rather than providing clear guidance on the accounting treatment of credit insurance and surety contracts.

Credit insurers are concerned that such difficulties following the implementation of these rules, may cause reinsurers to exit the market, as t will force them to run a separate set of accounting rules for a minor activity in their respective portfolios. This would be a major threat to our industry as well as our clients, which are mostly the small and medium sized companies in search of insurance of risks related to domestic and international trade.

We consider the issues discussed in this letter as essential to the development of the credit insurance and surety business and hope our arguments will contribute to improving the international accounting standards. We thank you for the opportunity to present our views on this important matter and look forward for further discussions with the IASB regarding the proposed amendments on IAS 32 and IAS 39 as well as related issues to the DSOP on insurance contracts.

Sincerely,

Robert Nijhout

Executive Director
International Credit Insurance & Surety Association

ANNEX 1

ICISA MEMBERS

Group Members:

Coface Group
Euler & Hermes Group
Gerling NCM Group

Reinsurance Members:

Converium - Switzerland
GE Frankona - Germany
Hannover Re - Germany
Munich Re - Germany
Swiss Re – Switzerland

Members:

Allianz Corporate Ireland - Ireland
AXA Assurcredit – France
CESCE – Spain
Chubb – Federal Insurance - USA
CLAL – Israel
CNA Surety - USA
Concordato – Italy
Cosec – Portugal
Credit Guarantee – South Africa
Credito y Caucion - Spain
Dansk Kaution – Denmark
ECICS – Singapore
Eidgenössische - Switzerland
Ethniki – Greece
Fianzas Atlas - Mexico
Gothaer - Germany
Guarantee Company of North America - Canada
Mapfre - Spain
Mitsui Sumitomo – Japan
Nationale Borg - Netherlands
Prisma Kreditversicherung - Austria
QBE Insurance (Australia) – Australia
Seoul Guarantee – South Korea
Sompo Japan Insurance - Japan
St. Paul Surety – USA
Tokio Marine – Japan
Travelers Casualty and Surety - USA
Warta – Poland
Zurich Agrippina - Germany
Zurich GSG – United Kingdom