ICISA
INTERNATIONAL CREDIT
INSURANCE & SURETY
ASSOCIATION

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

Amsterdam, the 20th October 2004

Exposure Draft on Amendments to *IAS 39 Financial Instruments: Recognition and Measurement* and *IFRS 4 Insurance Contracts*

Dear Sir David,

This letter is sent on behalf of the members of the International Credit Insurance & Surety Association (ICISA) and of the Pan American Surety Association (PASA). A full list of members of both associations is attached to this letter as an addendum.

We are writing to comment on Exposure Draft on Amendments to *IAS 39 Financial Instruments: Recognition and Measurement* and *IFRS 4 Insurance Contracts.*

We fully support the Board's objective of improving accounting standards worldwide and appreciate the ongoing efforts made to address more particularly the specifics of insurance and surety bond contracts. However, we feel that these specifics have not been fully taken into account by the Exposure Draft as the proposed definition of "financial guarantee contracts" does not attempt to make a difference between credit insurance and financial guarantees, although they are fundamentally different in substance.

Our answers to the questions set in the Exposure Draft are set out here below. We have tried, as in our previous comment letters, to suggest alternative wording where we thought it would increase the likely benefits for the users of financial statements.

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 or insurance contract. Under the proposals in the exposure draft the legal form of such contracts would not affect their accounting treatment.

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?

We do agree on the general principle set up by the IAS framework that the legal form of contracts should not determine the accounting treatment.
Nevertheless, what has been set up by IASB is that the substance of the contract defines its accounting treatment.

Consequently, IFRS 4 has set a definition of an insurance contract which is (Appendix A) : "An insurance contract is a contract under which one party accepts significant insurance risk (and no other risk, like a financial one) from another party by agreeing the policyholder to compensate the policyholder if a specified uncertain future event adversely affects the policyholder". The application of this definition leads to include in the scope of insurance contracts : "credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtors fails to make payment when due".

On this basis, this exposure draft is unnecessary.

Should credit insurance and financial guarantee be accounted similarly because of the following rationale first expressed in the DSOP?

> *"Although credit insurers manage credit risk by pooling individual risk within a portfolio, banks also do this in managing the credit risk in a portfolio of financial guarantees. Although banks may rely more on collateral, this is no reason to require a different accounting treatment."*

We disagree with this parallel as in practice it does not work.

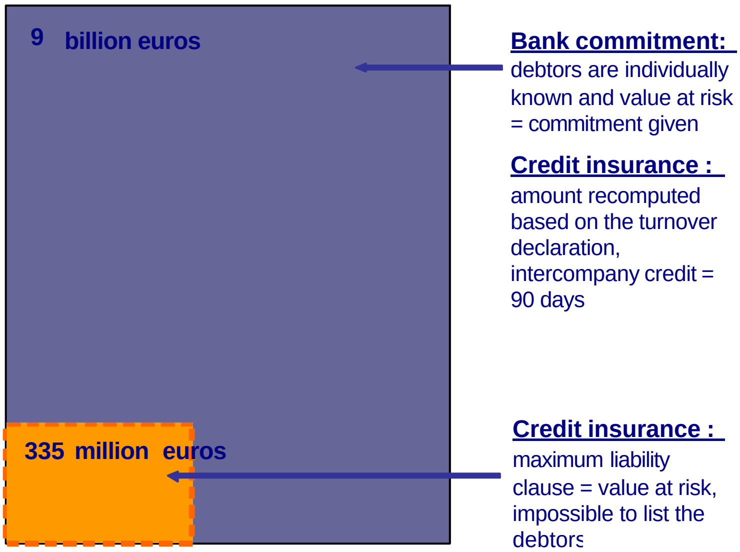
In the day to day guarantee business, banks manage their credit risk by choosing client by client. Basically their choice is based on their assessment of each individual solvency and it is doubtful that they would ever cover an uncertain client just because he or she brings diversification in their so-called "portfolio of risks". As such, there is no portfolio logic within their decision process which is more similar to a loan decision process – hence, the loan commitment rationale we will further develop.

On the contrary, credit insurers are bound to have a portfolio approach, because they know neither the existing receivables nor the future ones to be covered. Credit insurers will therefore seek to diversify as much as possible, for instance by covering different trade sectors to avoid any unknown accumulation of risks. They are ready to write business in a difficult sector all the more so as they resort to insurance techniques to manage their risk. To some extent, the diversification principle leads them to replicate within their portfolio the relative weight of each trade sector of the economy in which they operate.

One of the most powerful insurance tool which is used and makes credit insurance different from financial guarantees is the Maximum Liability Clause as this clause makes useless in practice the disclosure of its individual risks by the credit insurer.

The impact of this clause can be illustrated by the following example:

The idea is to compare the potential impacts for a bank issuing financial guarantees up to an amount of €9 billion and for a credit insurer covering trade receivables with an outstanding of €9 billion (the computation for the credit insurer was based on the declared turnover by its clients under the assumption that corporates pay at 90 days, i.e.: €36 billions turnover declared * 90 days / 360 days = €9 billions).



In the case of the bank, its commitment would be the issued a guarantee on €9 billion.

In the case of the credit insurer, its commitment would be a multiple of its premium and in that case €335 million (impact of the Maximum Liability Clause).

For the same amount covered, the two commitments speak for themselves 9 billion for a bank, €335 million for a credit insurer.

These figures stem from an actual credit insurance portfolio and the equivalent commitment for a bank has been recomputed. On top of the impact of the Maximum Liability Clause, these figures incorporate the impact of other insurance techniques such as deductibles and co-payment.

This actual case shows that the diversification made by credit insurers and the insurance techniques they use, result in a high dilution on the risks. This is not the case with banking financial guarantees as these guarantees are always individual.

Accounting had to reflect these differences between the amounts at risk notably by allowing credit insurers to resort to insurance accounting.

Therefore, Credit insurance should remain within the scope of IFRS 4 and should in the interim phase until phase II be accounted for in the same way as other insurance contracts.

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 "a 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 the proposed scope appropriate?

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

We find the proposed definition inappropriate.

As it has already been agreed credit insurance contracts are insurance contracts, the proper scoping is IFRS 4. In addition, the reason expressed in the basis for conclusions of the Exposure Draft (the recognition of a liability at inception of the financial guarantee) is not relevant for credit insurers who have always done so and who continue to do so under the scope of IFRS 4.

Moreover writing a single risk (based on a single counter party) is different from insuring credit risks. When diversifying their portfolios, banks still consider the individuality of each risk managed line by line as loan commitments whereas diversification is consubstantial to credit insurance either at the level of the insured or at the level of the insurer (see Form of contract).

Thus, considering that issuers (whether banks or corporate entities) assess the risk of their financial guarantees as potential loans, we tried as a way forward to suggest the following alternative wording.

> **§ 9 of IAS 39**: "A financial guarantee contract is a contract **(i)** 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 and **(ii) the nature of which is comparable to a loan commitment as it is settled through a loan to the party whose obligation is being guaranteed in the event of an adverse effect.**
> **Those financial guarantee contracts meeting criteria (i) but not criteria (ii) are in the scope of IFRS 4 as they are insurance contracts."**

We believe that the substance of this alternative wording is consistent with the requirements expressed in the Exposure Draft as:

- ➔ insurance against credit risk: a) is already measured initially at fair value, b) recognises a liability upon issuance of a policy through the IBNR (Incurred but not recorded) and c) subsequently has a liability adequacy test similar to the prescribed measurement of IAS 37.
- ➔ all the other financial guarantees whether issued by a corporate entity or by a bank would be in the scope of IAS 39 and therefore meet the objectives of the Exposure Draft.

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 (i.e. fair value) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 Revenue.

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

This proposal is inappropriate because IAS 37 and IAS 18 do not deal up to now with the specifics of an insurance contract or raise measurement questions when it comes to apply them to insurance contracts which will be solved in Phase II only.

It does not add anything to the credit insurers' existing accounting policies and lacks guidance for all the insurance features hosted within the credit insurance contract. We try here below to detail all those specific features and explain all the accounting issues that they raise:

- **Premiums :**

Premiums are primarily based on policyholders' turnover or trade receivables that vary according to changes in turnover. Premium income therefore depends directly on the volume of the policyholder's sales, that is not known at inception but only when the guarantee is extinguished. At every closing date, there is a statistical estimation of the undeclared turnover that is booked in the profit and loss account (Earned premiums but not written).

Once the ultimate premiums are estimated (including this "Earned premiums but not written"), they are amortised over the life of the contract.

It is not clear, with references to IAS 18 and IAS 37, how premiums should be measured, amortized and presented (written premium, unearned premium, earned premium)?

- **Deferred acquisition cost**

In the existing accounting practices, the insurance margin (premiums, minus claims and expenses) is spread over the life of the guarantee.

Acquisition costs that include commissions and internal expenses related to contract preparation are deferred over the life of the contracts.

In the Exposure Draft (BC 23c), it is stated that: "Costs of originating the contract would be added in additional interest expenses over the life of the contract".

What is an interest expense in credit insurance?

- **Salvages and recoveries**:

Recoveries represent amounts to be recovered out of pending claims. They can occur either:

- before the claim is paid, insured should notify past due receivables to the insurer. This notification opens a waiting period of 2 to 6 months to pay the claim. During this lapse of time, insurers try to recover the amount to avoid paying the claim to the insured. The recoveries before indemnification represent more than 30% of the claims notified ;
- after the claim is paid, the collection process continues to the benefit of the insurer and lead to a recovery of around 15% of the indemnities paid.

Those recoveries are booked at inception (in most European Countries) when the contract is signed and estimated by statistical methods.
The ultimate loss expenditure includes an estimate of this probable recovery even before any claims have been paid

Should we consider that the two types of recoveries meet the definition of a contingent asset as set by IAS 37 *"A contingent asset is a possible asset that arises from past events and whose existence will be confirmed by the occurrence or non occurrence of one or more uncertain future events not wholly within the control of the enterprise"*?

If so, then those recoveries would decrease the technical cost at inception. If not, than this decrease in the technical cost would only be booked at the time the recovery has been made.

- **Risk and uncertainty :**

IAS 37 refers to risk and uncertainties. Since the DSOP, this measurement issue gives rise to endless discussions which are just about to restart in the context of Phase II. The Exposure Draft proposes that credit insurers apply IAS 37 in subsequent measurement. How should credit insurers apply it before more work is performed in the context of Phase II?

The main issues are:

- How should the amount of uncertainty be assessed?
- Should it reflect the risk premium that market place participant will demand?
- Should it reflect other notions such as provision for "risk adverse deviation" or "prudence»?
- Should the cost of capital be taken into account in the calculation?

- **Discount :**

IAS 37 refers to discount. Discount is also at the heart of Phase II discussions, together with the issue of the inclusion of the credit rating (of the instrument? of the entity?) in the measurement. How should any discount be applied before Phase II?

- **Renewals, cancellation and continuation options :**

Credit insurance contracts are annual or pluri-annual contracts. They are cancelable at the option of the policyholder. Yet, we have never seen a policyholder cancel its contract at the beginning of a depressed economic cycle nor have we seen an insurer change significantly its rate over the economic cycle.

One of the most complex area of Phase II relate to how to include renewals in the measurement of insurance contracts. How should it be addressed by credit insurers before Phase II?

- **Reinsurance :**

Credit insurers (as the other non-life insurers) cover their risks through reinsurance contracts (‘treaties’):

- Quota share treaty: a part of the premiums and of the claims is ceded to reinsurers against the payment of a commission. This commission is calculated by reference to the written premiums and then is deferred and recognized in the profit and loss on the same basis that ceded unearned premiums ;
- Excess treaty: it covers an accumulation of losses on retained risks. Debtor cover protects insurers against losses resulting from the default of a debtor representing over a certain deductible. This treaty also exists for country risk.

It is not clear today in IFRS 4 whether reinsurance to be in the scope of IFRS 4 needs to cover “*an insurance*” or “*an insurance contract in the scope of IFRS 4*”.

In the first case, as credit insurance is an insurance contract, then credit insurance would be in the scope of IAS 39/37 and the reinsurance of credit insurance in the scope of IFRS 4 if the proposed Exposure Draft is not changed. Hence there will be a diskreptancy between the valuation of liabilities and the share of reinsurers in those liabilities (assets for insurers).
In the second case, the measurement of the reinsurance of credit insurance is still to be specified.

- **Performance features / Bonus malus (no claims bonus)**

Some policies include performance features which leads to the retrocession of a part of the profit to the insured if the margin of his policy (determined contract by contract over a one to three year period) overpasses a specified amount.

In the existing accounting policies, this probable loss is estimated and booked at inception even though it depends on the final result of the policy at the end of the above-specified period. IAS 37 is not clear on how this should be accounted for especially when the specified amount has not been reached?

- **Insurance contract acquired in a business combination or portfolio transfer :**

Paragraph 31 in IFRS 4 Insurance contract reads as followed**: "**To comply with IFRS3 Business Combination, an insurer shall at the acquisition date measure at fair value the insurance liabilities assumed and insurance assets acquired in a business combination» Because IFRS 3 gives no guidance on how to determine the fair value of the insurance liabilities, the existing accounting practices are not changed during phase I.
In credit insurers' balance sheet, business combination represents a very significant part of the total assets and liabilities.

For example, in Coface consolidated accounts as at the end of 2003, intangible assets and goodwill amounted to 35% of it equity.

If credit insurance is not scoped into IFRS 4, it is not clear whether or not, credit insurers may use, this exemption to maintain existing accounting policies as long as the phase II has not been achieved. Does it mean that credit insurers would have to determine the fair value of their portfolio without any guidance when they are not obliged to do it for the other non-life insurers?

* * *

For each of the above feature, the issue is the following:

- ➔ if credit insurance remains in the scope of IFRS 4, then credit insurers will handle the insurance features of their contracts with their existing practices which are comparable because they are all compliant with the EEC Directive of 1991 ;
- ➔ if insurance against credit risk is scoped under IAS 37/39, than credit insurers will need to interpret the conflicting requirements between IAS 37 versus existing practices (at least until Phase II); hence, different interpretations from accounts preparers or auditors could lead to discrepancies in the published financial accounts of credit insurers, thus making it difficult any comparison by an external party.

Consequently, we do ask that credit insurance accounting principles and specifics be determined in phase II under 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. The application would apply retrospectively.

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

If this Exposure Draft were applied, we consider its effective date as inappropriate.

The proposed effective date will lead credit insurers to change their accounts in 2005 (FTA), 2006 (Exposure Draft) and 2007 (Phase II). We believe these continuing changes would not meet the objective of making our accounts understandable and comparable to external parties.

Moreover, the IASB is due to revise IAS 37. We feel that all these changes should be synchronised.

Question 5 –Other Comments

Do you have any other comments on the proposals?

The current Exposure Draft proposed to measure financial guarantee contracts (and so far credit insurance contrast) initially at fair value, subsequently at the higher of the amount determined in accordance with IAS 37 and IAS 18, and therefore to disclose under IAS 32.

IAS 32 requires disclosures in order to provide information to assist users of financial statements in assessing the extent of risk related to financial instruments such as market risk, credit risk and liquidity risk. These disclosures (requirements) are not fully relevant to understand the risk of credit insurance contracts. They relate more to assets than to insurance liabilities, which are not directly exposed to financial market risks but rather to insurance features. In IAS 32, these insurance features are not listed and this situation may conduct to a reduction in the level of the information given and to a reduction in the comparability of the financial statements between credit insurers as each one of them will make its own understanding of IAS 32.

IFRS 4 requires to disclose risk management approach and terms and conditions of insurance contracts but also requires extensive disclosure on insurance risk which are not indicated in IAS 32 and which are more in line with the economics of the credit insurance contract.

These disclosures on insurance risks include:

- sensitivity analysis :
  - ⇒ qualitative/ quantitative,
  - ⇒ effects of changes in key variance,
  - ⇒ impact of correlation between key variables.
- claims development tables,
- concentration of insurance risks
  - ⇒ coverage of insurance contracts,
  - ⇒ single incidents giving large exposure,
  - ⇒ unexpected changes in trends, financial markets.

In the notes to their financial statements credit insurers already provide most of those items.

Claims development tables for example are information that credit insurers already provides. For IFRS 4 requirement, these tables will present 5 years of claims development, by accident year or underwriting year, gross and net of reinsurance, with an indication of unusual claims development.

For concentration of insurance risks, there is also a disclosure made before and after reinsurance. This piece of information is a good way to understand the exposure on the insurance liabilities.

Last but not least, under IAS 32 the fair value of financial guarantee would need to be disclosed. Credit insurers will have difficulties to determine the fair value of a credit insurance contract as the principles of measurement of insurance contract at fair value is still due for Phase II.

As a conclusion, all the information needed to understand the credit insurance business are clearly addressed by IFRS 4 and not by IAS 32 which focus on disclosure regarding risks in financial instruments. Disclosing under IFRS 4 would thus permit credit insurers to keep comparable and consistent information on credit insurance contracts as the requirements are very similar to credit insurer's current practice and as the implementation guidance in IFRS 4 is very detailed.

ADDENDUM

MEMBERS 2004

Australia
QBE Insurance Ltd.

Austria
ÖKV Coface AG
Prisma Kreditversicherungs AG

Belgium
Atradius
Euler Hermes Credit Insurance Belgium SA

Canada
The Guarantee Company of North America

Czech Republic
Euler Hermes Cescob Uverova Pojistovna AS

Denmark
Atradius
Dansk Kautionsforsikring Aktieselskab

France
Atradius
Axa Assurcredit
Coface
Etoile Commerciale SA
Euler Hermes SFAC

Germany
Algemeine Kredit Coface AG
Atradius
Euler Hermes Kreditversicherungs AG
Hannover Re AG
Munich Re
Zürich Versicherung AG (Deutschland)

Greece
The Ethniki SA

Hong Kong
Euler Hermes Kreditversicherungs AG-Hong Kong Branch

Hungary
Euler Hermes Mapgyar Hitelbiztosító RT

Indonesia
Askrindo

Ireland
Allianz Corporate Ireland Plc

Israel
CLAL Credit Insurance Ltd.
B.S.S.CH. - The Israeli Credit Insurance Company (ICIC)

Italy
Atradius
Concordato Cauzione Credito
Euler Hermes SIAC
Viscontea Coface SPA

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Sompo Japan Insurance Inc.
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Seoul Guarantee Insurance Company

Luxembourg
Namur Re

Mexico
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Fianzas Atlas SA

The Netherlands
Atradius
Coface Nederland
Euler Hermes Interborg
Euler Hermes Kredietverzekering NV
NV Nationale Borg Maatschappij

Norway
Atradius

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Warta Insurance & Reinsurance Company Ltd.

Portugal
Cosec SA

Singapore
ECICS Credit Insurance Ltd.

South Africa
Credit Guarantee Insurance Corporation of Africa Ltd.

Spain
Coface Iberica
Cesce SA
Crédito y Caución SA
Mapfre Caución y Crédito SA

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Euler Hermes Credit Insurance Nordic AB

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Atradius
Converium Ltd.
Euler Hermes Services AG
Partner Re Ltd.
Swiss Reinsurance
Winterthur Insurance

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De Montfort Insurance Plc
Euler Hermes Guarantee Plc
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