The Life Insurance Association of Japan

GDV
DIE DEUTSCHEN VERSICHERER

November 2, 2004

International Accounting Standards Board
30 Cannon Street, London EC4M 6XH,
United Kingdom

ED Amendments to IAS 39 and IFRS 4: Financial Guarantee Contracts and Credit Insurance

Dear Sir David,

This letter is submitted on behalf of the Life Insurance Association of Japan (LIAJ), and the German Insurance Association (GDV). The LIAJ is the industry organization composed of all life insurance companies in Japan whose purpose is to promote development and public trust in the Japanese life insurance industry. The GDV, with its 447 members, represents about 97% of the German insurance market calculated by premiums written.

These associations appreciate the opportunity to comment on the Exposure Draft of Proposed Amendments to IAS 39 and IFRS 4: Financial Guarantee Contracts and Credit Insurance. We are convinced that all contracts meeting the definition of an insurance contract in IFRS 4 should be within the scope of IFRS 4. This means that for example credit insurance contracts that contain the same features as all other insurance contracts (i.e., that meet the definition of an insurance contract in IFRS 4) should remain within the scope of IFRS 4, too. However, such financial guarantees as loan commitments should be accounted for according to IAS 39.

General Remarks

It is important to understand that credit insurance contracts and financial guarantees are two different issues. Whereas financial guarantees are financial instruments, credit insurance contracts are insurance contracts meeting the definition of an insurance contract in IFRS 4. It is not consistent for credit insurance contracts to be within the scope of IAS 39. The reason is that they fulfill the requirements of an insurance contract in IFRS 4. The ED even says that these “requirements would apply even if the contract meets the definition of an insurance contract in IFRS 4" (IN3). Such an approach would not be systematic.

According to its Constitution, the objective of the IASC Foundation is, inter alia, "to develop […] a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information […]". We believe that by aiming at publishing the ED the objective is failed. One cannot develop a *single* set of high quality and *understandable* accounting standards on the one hand, and, on the other hand, require contracts to be outside the scope of a standard although the standard covers all types of those contracts.

As for the nature of credit insurance contracts, all characteristics and tools that apply to insurance contracts also apply to credit insurance contracts. The insurance business works by pooling the individual insurance risks within the portfolio (the so-called portfolio approach) and over time. Furthermore, the insurance business is characterized by stochastic processes. The credit insurance business is by no means different from that. Requiring a different treatment of credit insurance contracts and all other insurance contracts is equivalent to neglecting the principle "substance over form" (Framework 35). Hence, because of its nature (i.e., economic substance) as well as its legal form a credit insurance contract is a typical insurance contract.

According to IFRS 4.1 (a), only limited improvements to accounting by insurers for insurance contracts are required. The reason is that IASB's Insurance Project is divided into two phases. When discussing and adopting IFRS 4, the Board agreed upon that only marginal changes are made with the objective of solving all the aspects concerning insurance contracts in Phase II. In order to prevent insurance companies from having to adapt to changes twice, IFRS 4 as the resulting Standard of Phase I introduces just limited changes. We welcome this approach.

However, IASB intends to exclude credit insurance contracts from this approach. It is IASB's idea to introduce major changes to the accounting of credit insurance contracts. The consequence is that contracts with identical characteristics, i.e. credit insurance contracts and all other insurance contracts, are treated in different ways. From our perspective, an approach distinguishing between credit insurance contracts and all other contracts is arbitrary and useless. We will return to this point.

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.

We strongly believe that it is not the legal form, but the economic substance that should determine whether a contract is an insurance contract. From this particular angle, a credit insurance contract is substantially different from a financial guarantee.

In the case of a financial guarantee, the focus is on the debtor. A financial guarantee is a contract between the guarantor and the debtor. In contrast to financial guarantees, the focus of credit insurance contracts is on the supplier (creditor). A credit insurance contract is a contract between the insurer and the supplier (creditor).

As for credit insurance contracts, the default of the customer is beyond the supplier's control. This means the credit insurer is able to apply a portfolio approach by pooling individual risks in a portfolio. The consequence is that the future cash flows arising from credit insurance contracts are at random which gives the credit insurer the chance to apply stochastic models. This is done analogously in the case of all other insurance contracts and is a major difference from the management of financial guarantees.

The management of financial guarantees is done on the basis of every single contract. Stochastic methods that are key to the management of (credit) insurance contracts are irrelevant for financial guarantees.

Quite a few more differences between credit insurance contracts and financial guarantees can be listed. Altogether,

- financial guarantees deal with specific exposures whereas credit insurance contracts cover overall turnover, regardless of the number of counter-parties involved. In this way, credit insurance covers a group of risks within a contract with one customer, whereas a financial guarantee given by a bank does not;
- credit insurance contracts include features, such as deductibles, percentage of coverage and maximum liability that are typical for credit insurance but not for financial guarantees issued by banks;
- financial guarantees issued by banks are based on the assessment of a company's credit-worthiness (= assessing the occurrence of an adverse event) whereas credit insurance insures the credit component of the risk of selling (assessing the occurrence of an adverse event + probability that the insured will incur a loss);
- financial guarantees by banks are comparable with loans, the only difference being that there is no cash flow. Often, financial guarantees are collateralised. In case of a loss, the collateral is sold in order to mitigate the loss. Credit insurance companies hardly ever have collateral. They are, however, subrogated and become unsecured creditors;
- the management of financial guarantees is comparable to the management of loan commitments. A loan can be an instrument to settle the financial guarantee;
- if a bank issues a financial guarantee, it generally does not provide any other services explicitly linked to the guarantee, whereas credit insurance contracts are usually combined with services such as assessment and encashment;
- there is a conditionality between coverage and the claim for benefits;
- the policyholder is required to proof that he has incurred a loss. Insolvency by itself is not sufficient;

- in case of a credit insurance contract, the default is outside the control of the holder. As a consequence, credit insurance is less or even not at all subject to moral hazard;
- if policy provisions are not met, the policyholder's rights arising from the contract extinguish.

The differences of the contracts are also to be reflected in the accounting of the contracts. From our perspective, a separate treatment of credit insurance contracts on the one hand and all other insurance contracts on the other hand is misleading to the users of financial statements.

We believe the shortfalls could be settled by linking the definition of a financial guarantee closely to a loan commitment. The reason is given above.

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 understand that the proposed definition of financial guarantees is guided by the idea to create a common groundwork for both financial guarantees and credit insurance contracts. However, we are convinced that there are material differences between these types of contracts. We have given an extensive overview of this issue in the answer to question 1. Hence, we believe that not (only) the definition of financial guarantee contracts, but IASB's overall approach to the accounting of credit insurance contracts is wrong. From this perspective, we agree neither with the proposed definition nor with the overall approach. An explanation of our view is provided in the answer to question 1.

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?

Subsequent measurement may be appropriate for financial guarantees comparable to loans. It is not appropriate for insurance contracts.

The Board's objective is to ensure that financial guarantees are shown on the balance sheet and not only off-balance (BC7, BC22), to which we agree. Nevertheless, no new rules are needed for credit insurance contracts, as they are already shown on the liabilities side under IFRS 4, on the one hand, as unearned premiums and on the other as IBNR. The liability adequacy test ensures that the liability is accounted for at the appropriate value. Even the Board states that application of IAS 39/37 will have only slight effects on the results. We therefore do not see any need for changing a method that is known and accepted – and understandable to the balance sheet reader – to a method which raises many questions (see above and also as regards how to measure insurance features under IAS 37) and forces the companies to reorganise their accounting and valuation.

Moreover, in our opinion, the proposed accounting method will lead to confusion as a typical insurance transaction should be disclosed as a "financial instrument" and therefore simply as a "liability" whereas all other insurance contracts are disclosed as "gross underwriting provisions". The user of a financial statement would expect all insurance contracts to be treated in an identical manner. We do not believe this supports the objective of a "true and fair view" or consistent reporting.

Phase II of IASB's insurance project will provide a more extensive guideline on how to account for insurance contracts. We are convinced that credit insurance contracts should also be within the scope of Phase II. A common treatment of all insurance contracts offered by an insurance company would allow the company to use a uniform accounting approach.

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 do you propose, and why?

Supposing the amendments are adopted in spite of all the arguments against them, we regard the effective date and transition as inappropriate. Insurance companies will have to consider changes in the accounting methods of insurance contracts in 2005 (IFRS 4), 2006 (amendment IAS 39) and when Phase II becomes effective. We do not think this will make our annual reports more understandable, therefore such an amendment should not be detached from the effective date of Phase II.

Question 5 – Other comments

Do you have any other comments on the proposals?

In our understanding, the proposals are meant to minimise the differences between IFRS and US GAAP. Under US GAAP financial guarantees are governed by FIN 45. Credit insurance contracts are explicitly exempted from FIN 45 and have to be accounted for under specific statements to insurance companies. The Board did not follow the accounting rules in US GAAP but chose another way that is "more relevant and reliable" in their opinion. As we demonstrated above, the accounting method chosen by the IASB will lead to less reliable financial statements, because it discounts the obvious economic differences between financial guarantees and credit insurance contracts.

If you have any questions concerning this letter, or would like further information on any of the comments made, please do not hesitate to contact us.

Respectfully submitted:

LIFE INSURANCE ASSOCIATION OF JAPAN
GERMAN INSURANCE ASSOCIATION