acteo Association pour la participation des entreprises françaises à l'harmonisation comptable internationale

Mouvement des Entreprises de France
MEDEF

Ms Sandra Thompson
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JK/SJ/10.2004/43
RE : IAS 39 : Financial guarantee contracts and credit insurance

Paris, October 8th, 2004

Dear Ms Thompson,

ACTEO & MEDEF welcome the opportunity to comment the IASB exposure draft on IAS 39: Financial guarantee contracts and credit insurance.

As detailed in the appendix to this letter, we do not believe that financial guarantee contracts and credit insurance contracts are similar in substance. We therefore reject all decisions made by the Board on this assumption.
We otherwise agree with the proposals, if and when they apply to financial guarantee contracts that do not transfer any significant insurance risk.

We remain at your disposal should you need further clarification or background information.

Yours sincerely,

ACTEO
Philippe CROUZET
Le Président

P/O Jean KELLER

Le Délégué Permanent

MEDEF
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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 of course agree with the basic principle that substance should prevail over form in defining the appropriate accounting treatment of transactions. However we do not think that the application of this basic principle leads to the conclusion that credit insurance contracts and financial guarantees ought to be accounted for in the same manner. Credit insurance contracts and financial guarantees are indeed different in substance, not only in legal form, and it is on the basis of this difference in substance that they need to be accounted for in different ways.

1) *Credit insurance contracts are in substance insurance contracts and ought to be accounted for accordingly*
   Credit insurance contracts have all the characteristics of other insurance contracts and are therefore fully encompassed by the definition of an insurance contract as set out in IFRS 4, Appendix A: "a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder". And insurance risk is defined as "risk, other than financial risk, transferred from the holder of a contract to the issuer.
   Accordingly they ought to be accounted for as other insurance contracts, in order to satisfy the "substance over form" principle.

2) *Credit insurance contracts and financial guarantees are different in substance*
   The exposure draft acknowledges that credit insurance contracts meet the definition of insurance contracts as set out in IFRS 4. Implicitly the Board classifies the so-called "financial guarantees" into two categories:
   - "financial guarantees" which would include significant insurance risk and would therefore meet the definition of an insurance contract;
   - "financial guarantees" which do not transfer significant insurance risk.

   We believe that **the transfer of significant insurance risk embodies a significant difference of substance** between two transactions that could otherwise be considered alike.
   In substance, a financial guarantee which does not transfer any significant insurance risk can be analyzed as the combination within a single instrument of:
   - a loan commitment, the loan being conditional to a failure in payment,
   - a loan with interest, in case the failure occurs.

   We therefore recommend that financial guarantees which are not insurance contracts be accounted for in conformity with their substance, i.e. as loan commitments. According to the existing IAS 39, those financial guarantees would fall into the scope of IAS 37 for all subsequent measurements, and therefore satisfy the Board's proposed requirements.

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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 do not consider the proposed scope as appropriate. As stated in our answer to question 1, there are two types of financial guarantees that ought to be accounted for in accordance with their substance.

Accordingly:

- credit insurance contracts, i.e. "financial guarantees" that transfer significant insurance risk fall naturally under the scope of IFRS 4;
- financial guarantees that do not transfer significant insurance risk fall under the scope of IAS 39.

We furthermore suggest that clear definitions and specific labels be retained:

- financial guarantees should be defined as "contracts that require 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, without transferring any significant insurance risk".
- Credit insurance contracts are "contracts that require 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 that transfer significant insurance risk from the policyholder to the insurer".

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.

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

Do you have other comments on the proposals?

We believe that this proposal is appropriate to deal with financial guarantees which meet the definition proposed in our answer to question 2, i.e. contracts which do not transfer significant insurance risk.

We however consider that the proposal is inappropriate for credit insurance contracts.

Credit insurance contracts being in substance insurance contracts ought to be accounted for in accordance with IFRS 4, for the very same reasons for which IFRS 4 was issued and insurance contracts scoped out of IAS 39.

Credit insurance contracts, beyond their common denominator with financial guarantees, include all the features of other insurance contracts. Beyond the valuation of the liability incurred, many other issues are raised by credit insurance contracts which are adequately dealt with under IFRS 4:

- recognition of revenues,
- accounting for acquisition costs,
- accounting for reinsurance,
- performance features,
- partial insurance risk transferred,
- portfolio transfer,
- ...

Insurance contract phase 2 is set out to deal with all these different features which characterise credit insurance contracts as well as other insurance contracts. IFRS 4 is the standard applicable, pending the completion of that project.

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?

We agree that the proposed accounting treatment be applied retrospectively to financial guarantees that do not transfer any significant insurance risk, as of 1 January 2006. No change should be decided in relation to credit insurance contracts.

Question 5 –Other Comments

Do you have any other comments on the proposals?

We do not have any other comment.