European Financial Reporting Advisory Group

15 October, 2004

CL 51

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
UK

Dear David,

Re: ED of proposed amendments to IAS 39 Financial Instruments: *Recognition and Measurement* and IFRS 4 *Insurance Contracts: Financial Guarantee Contracts and Credit Insurance*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the exposure draft of proposed amendments to IAS 39 and IFRS 4: *Financial Guarantee Contracts and Credit Insurance* ("ED Credit Insurance"). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issues.

Whilst we are sympathetic to IASB's view that similar financial products with different legal form should be accounted for in the same way, we are not satisfied that credit insurance, and financial guarantee contracts are so similar in substance that both should be accounted for in the same way. In our view credit insurance, as applied in Europe, is usually an insurance product, no different from other insurance products and should be accounted for under IFRS 4 *Insurance Contracts*. On the other hand, financial guarantee contracts, as applied in Europe, are essentially pure credit contracts of a very different nature.

We believe that unnecessary disruption by forcing a change to credit insurers' accounting even before phase II is further developed should be avoided. Indeed the IASB has committed itself when developing IFRS 4 to limiting interim changes for insurance contracts while the whole subject is under review in phase II.

Further, we believe that the definition of financial guarantee contracts as proposed by the new paragraph 9 in IAS 39 needs to be further developed. Any overlap between the definition of (credit) insurance contracts and financial guarantee contracts would lead to the result that certain financial guarantee contracts would fall under IFRS 4 and certain insurance contracts would fall under IAS 39. Therefore, this amendment to IAS 39 should result in a clear distinction between contracts covering pure financial risk and contracts covering significant insurance risk.

Overall, we take the view that credit insurance products, which comply with the definition of insurance contracts should remain in the scope of IFRS 4 and should in the interim phase whilst phase II is developed be accounted for in the same way as other insurance contracts.

However, if the IASB is concerned that the liability adequacy test as required by IFRS 4 could in certain cases result in credit insurance liabilities being measured at an amount less than IAS 37 would require, we – without having in depth explored the proposal - recommend the Board to consider amending IFRS 4 to require use of IAS 37 as a mandatory liability adequacy test for credit insurance contracts until phase II has been finalised.

If you would like further clarification of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

ED of proposed amendments to IAS 39 Financial Instruments: *Recognition and Measurement* and IFRS 4 *Insurance Contracts: Financial Guarantee Contracts and Credit Insurance*

<u>Question 1 – Form of contract</u>

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.

<u>EFRAG response:</u>

We agree that the legal form of contracts should not affect their accounting treatment. However, we believe that credit insurance contracts are different in substance from financial guarantee contracts. Credit insurance contracts are written to cover a client's entire book of receivables and therefore at subscription it is impossible to assess the inherent risk. This is the reason why credit insurers make use of stochastic methods and pool risk in portfolios which is the way insurance companies generally deal with (significant) insurance risk. This is in contrast to financial guarantee contracts, which are written to cover the credit risk of individually known and specific debtors.
In addition the parties involved in the two products differ. In the case of a financial guarantee the issuer, the holder and the party whose obligation is guaranteed are aware of the existence of the guarantee, in the case of a credit insurance contract only the insurance company and the policyholder are directly involved in the contract. This results in a different degree of risk.

Furthermore, if the debtor fails in a financial guarantee contract, the claims paid change into a loan on which financial interest is calculated; this may qualify them rather as loan commitments. This is not the case for credit insurance contracts, for which no interest is calculated. Credit insurers instead try to recover the nominal amount of the receivable from the debtor.

Credit insurance usually involves extensive service features, as for example, cash management and management support in avoiding claims and insolvency. In that way it is also different in substance to a financial guarantee contract.

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?

EFRAG response:

We do not believe that the definition of financial guarantee contracts as proposed in the exposure draft is appropriate. The criterion of significant insurance risk is included in the general definition of an insurance contract in IFRS 4 and should consequently be taken into account.

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?

EFRAG response:

We believe that this proposal is appropriate for financial guarantee contracts. For insurance contracts, we recommend that the IASB waits for the finalisation of phase II of the project on insurance contracts before introducing piecemeal changes to IFRS 4.

If the Board is concerned about the robustness of liability adequacy tests as required by IFRS 4 for application to credit insurance contracts, we – without having in depth explored the proposal - suggest the Board consider amending IFRS 4 and requiring application of IAS 37 as the (minimum) liability for such contracts. That change could ensure an equivalent measurement of the liability to that arising on financial guarantees while allowing credit insurers to continue other aspects of their accounting under IFRS 4.

Furthermore, we would also like to point out that in contrast to the aim of this exposure draft, different business concepts may lead to significantly different accounting treatments under IAS 37: by applying IAS 37.24 credit insurers will usually take a portfolio approach to determine the probability of outflows. In contrast, the issuer of a financial guarantee contract may assess on a client by client basis whether the outflow of resources is probable or not, i.e. whether the event is more likely to occur than not.

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?

EFRAG response:

Since we do not support the proposed changes in the exposure draft this question is not applicable. Nevertheless, if the proposal were to result in a final amendment to IAS 39 and IFRS 4 we believe that retrospective application of new standards and amendments to existing standards should be applied. Only in exceptional cases where it is impracticable to apply it retrospectively would we support that transitional requirements be prospective in nature.

Question 5 – Other comments

Do you have any other comments on the proposal?

EFRAG response:

We support the amendment related to loan commitments.