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

Wien, am 07.10.2004

Dear Sir David Tweedie,

the Austrian Insurance Association (VVO) has discussed the amendments proposed in the Exposure Draft issued in July 2004 with its members. As a result of this discussion the Austrian insurance enterprises oppose strictly and unanimously the exclusion of credit insurance contracts from the application of IFRS 4.

The IASB states that financial guarantees and credit insurance contracts are not different in substance but only in form and both meet the definition of an insurance contract. The introduction to the amendments begins with the following sentences: "Financial guarantee contracts (sometimes known as "credit insurance") 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 .... Some financial guarantee contracts result in the transfer of significant insurance risk and thus meet the definition of "insurance contract" in IFRS 4."

The VVO agrees, that not only credit insurance contracts but also many financial guarantee contracts meet the definition of an insurance contract in IFRS 4; the VVO however does not agree at all, that there are no differences in substance between credit insurance contracts as they are issued by insurance enterprises and financial guarantee contracts as they are issued primarily by banks, but also by other entities (sometimes also by insurance enterprises) and by private persons.

The main substantial differences between credit insurance contracts and financial guarantee contracts are the following:

- In a credit insurance contract the initiative to establish the contract comes from the policyholder, who is the creditor of receivables from his clients (the debtors); normally the debtors are not involved into the contract, mostly they do not even know, that their debts to their supplier are insured. In the case of a loss the policyholder gets reimbursed by the insurer.

  In a financial guarantee contract the initiative to establish the contract comes from the debtor, who buys a guarantee in favor of his creditor in order to give him a collateral security.

- In most of the credit insurance contracts all the receivables originating from the sales to the clients of the policyholder included in the contract are insured up to a certain limit, fixed in the contract (global coverage over a specified period). In many credit insurance contracts deductibles, percentages of coverage and participation features are provided. The credit insurer does not know its exact exposure until a claim is made (statistical risk).

  Financial guarantee contracts are normally issued to secure a special receivable and not a portfolio of receivables (single risk basis).

- In credit insurance contracts the insurer is mostly entitled to reduce the limits for receivables from a certain client of the policyholder without canceling the insurance contract, which covers the risks of non payment of the receivables from several or many clients (debtors).

  As financial guarantee contracts normally secure only one receivable the issuer of the contract is not entitled to reduce his guarantee during the life of the contract.

- The policyholder of a credit insurance contract is obliged to inform the insurer about any event which may affect the creditworthness of a client included in the insurance contract, especially about delayed payments.

  In a financial guarantee contract neither the creditor nor the debtor are obliged to inform the issuer of the guarantee of changes in the financial position of the debtor.

- Financial guarantees can be collateralised in case of a loss. For credit insurance contracts collateral securities are absolutely uncommon; credit insurers normally mitigate or limit their loss risk by reinsurance contracts.

- Credit insurers have to cover the liabilities resulting from credit insurance contracts by specific investments regulated by law or the supervisory authorities. The amount of the premiums received or earned or the amount of the losses paid for credit insurance contracts form the basis for the capital (equity) requirements.

  No special regulations exist for the assets forming the counterpart to provisions set up for loss from financial guarantee contracts; the capital requirements of banks for financial guarantee contracts are derived from the nominal value of the guarantees.

- Insurance companies must comply insurance contract law and stick to the general terms of these.

The warrantors issuing financial guarantee contracts are free to agree conditions with their clients.

There are a lot of other differences (e.g. in pricing, risk assessment, loss treatment) between credit insurance contracts and financial guarantee contracts which may however be seen rather as differences in form and not in substance.

The VVO is convinced that the facts stated above prove that there are differences in substance between credit insurance contracts and financial guarantee contracts, neglecting those differences would not be in line with the principles governing the IASB-standards.

In addition the VVO would like to point out, that the exemption of credit insurance contracts from IFRS 4 would be absolutely inconsistent with the principle, that in phase 1 of IFRS 4 only limited changes in the accounting of insurance contracts are required if the accounting rules are in line with the national standards.

Great problems would come up, if the measurement rules of IAS 39 and IAS 37 had to be applied for the gross business; also in this case the rules of IFRS 4 would have to be applied for the reinsurance of credit insurance contracts because it seems impossible to find any difference between the reinsurance of credit insurance contracts and all other insurance contracts; the risks covered in credit insurance contracts and other insurance contracts are sometimes even reinsured in one reinsurance contract (e.g. in a stop loss contract).

Should however the IASB, in spite of the arguments given, insist, that there are no substantial differences between credit insurance contracts and financial guarantee contracts the only logical conclusion could be to adopt IFRS 4 for all contracts transferring credit risks. The VVO does not think, that this decision would be more reasonable than the decision to treat credit insurance contracts in an other way than all other insurance contracts, but it would be the only logical consequence if theoretical deliberations should have a higher priority than the aim to develop standards which are in line with the economic facts and give the best information to the users of financial statements.

The VVO answers the questions in the proposed amendments as follows:

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: 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.

VVO response

The VVO agrees that in principle not the legal form of a contract but its economic content should decide on its accounting treatment. But as the VVO has demonstrated, that credit insurance contracts are different from financial guarantee contracts not because of their legal form but because they are different in substance the solution proposed in the amendments is refused by the VVO.

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?

VVO response

The VVO agrees that all financial guarantee contracts but not credit insurance contracts should be in the scope of IAS 39 (See general remarks and 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?

VVO response

As the measurement rules of IAS 39 and 37 should not be applied to credit insurance contracts the VVO is not directly affected by this question.

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?

VVO response

As the VVO refuses strictly the proposed amendments concerning financial guarantee contracts and credit insurance contracts it does not see a need to give a comment to this question.

Question 5 – Other comments

Do you have any other comments on the proposal?

VVO response

No

With the best regards

Verband der Versicherungsunternehmen
Österreichs

Dr. Louis Norman-Audenhove
(General Secretary)