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

8th October, 2004

Hannover Re Comments to the ED of Proposed Amendments to IAS 39 Financial Instruments: *Recognition and Measurement* and IFRS 4 *Insurance Contracts: Financial Guarantee Contracts and Credit Insurance*

Dear Sir David

We appreciate the opportunity to comment on the Exposure Draft of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts: Financial Guarantee Contracts and Credit Insurance.

We principally support the International Accounting Standards Board's position that similar financial products should be accounted for in the same way and that the legal form of those products should not determine their accounting treatment.

However, we do not agree with the opinion that financial guarantee and credit insurance contracts both should be accounted for according to IAS 39 due to their similarity. Financial guarantee and credit insurance contracts are different in their economic nature. Whilst in our opinion credit insurance contracts are insurance products similar to other insurance products under IFRS 4, we view financial guarantee contracts typically as credit contracts that should be accounted for under IAS 39.

Furthermore, we do not share the concern that an issuer of a credit insurance contract may not recognise a liability when applying IFRS 4. This standard requires the application of a liability adequacy test and therefore, in our view, no specific requirements need to be applied on credit insurance contracts.

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Moreover, when developing IFRS 4 the Board stated that the objective of Phase I of the project on insurance contracts was to avoid major changes as long as the accounting treatment of insurance contracts in general is under consideration until Phase II is finalised with a comprehensive standard. We consider the proposed changes for credit insurance contracts major changes and, therefore, recommend to resolve the related recognition and measurement issues within the further development of Phase II.

Attached please find our more detailed comments in answer to the Board´s questions set out in the Exposure Draft.

If you wish to receive any clarification of these comments, please contact us.

Yours sincerely

Jens Chyba
Head of Competence Center
Group Accounting and Consolidation

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.

Hannover Re comment

Rather than focusing on the legal form of a contract, we agree with the IASB's view that this is irrelevant, the economic substance of a contract should determine its accounting treatment following the condition of "substance over form".

In our opinion the differences in legal form are only indicators of the fundamentally different business models underlying credit insurance and financial guarantee contracts.

We see a number of specific features which clearly distinguish credit insurance from financial guarantees.

Insurance against credit risk is demanded by suppliers asking for protection against customers default. This default is outside of the suppliers' control allowing the credit insurer to use stochastic methods to estimate future contractual cash flows because these are at random.

In addition, the risk is managed by pooling individual risks into a risk portfolio whereby the resulting credit insurance pricing is based on diversification effects and the usage of the law of large numbers.

In contrary, in financial guarantees the creditworthiness of each requesting debtor is verified in order to estimate the risk of every single contract.

Furthermore, the services offered in credit insurance contracts are different from those offered in financial guarantee contracts. Apart from the mere reimbursement, a whole package of additional services is usually offered (e.g. encashment, dunning activities) which is not the case with financial guarantees.

We further would like to point out that the credit insurer may refuse the payment of a claim or may delay payment while a claim is investigated. Traditional insurance tools such as individual or aggregate deductibles, percentage of coverage, maximum liability clauses, discretionary participation features and potential cancellation of the policy after any one loss are used to avoid moral hazard and adverse selection caused by asymmetric information on debtors.

On the contrary, in financial guarantees the guarantor usually has to pay at first notice irrespective of whether the default was fortuitous because a case of moral hazard does not influence the guarantors obligation to pay.

Another major aspect to be considered is that the above outlined features of credit insurance contracts are not tradeable in active markets and their prices cannot be assessed other than at inception. Their coverage is conditional and the indemnification is uncertain, to a large extent the risks are not individually known within the policies, their value depends on the contribution of stochastic independent risks to the global portfolio, portfolios are reinsured at inception and transfers of portfolios between insurers are regulated.

Given the fundamental differences in the economic substance between credit insurance and financial guarantees, we strongly recommend the application of IFRS 4 on credit insurance contracts for the time being (we refer to our comments on question No. 4).

<u>Question 2 – Scope</u>

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?

<u>Hannover Re comment</u>

We consider the proposed scope inappropriate and it is our impression that credit insurance might have been erroneously mixed with financial guarantees provided by banks.

To the extent that credit insurance contracts transfer significant insurance risk, they clearly meet the definition of insurance contracts because whether and when a contractually specified future event will occur is as uncertain as the number of possible claims at the date of inception of the contract. As laid out in our comment to question No. 1, credit insurance specifically adds insurance features to the pure guarantee component. Like other insurance contracts credit insurance contracts carry specific insurance features including acquisition costs, salvage and recoveries, reinsurance accounting, performance features, deductibles and renewal options and rights. Guidance for these specifics can in our view only be given in the insurance standard and not in IAS 39.

In light of the fact that the IASB confirms that credit insurance contracts meet the definition of insurance contracts, we consider the conclusion that these contracts also meet the definition of a financial guarantee and should, therefore, be accounted for according to IAS 39 as inconsistent and do not understand the arguments for an exclusion from the scope of IFRS 4.

In our opinion the exclusion of credit insurance seems to be arbitrary and conceptually unfavourable at this point in time. This exclusion completely contradicts the spirit of Phase I in which the IASB has committed itself not to prescribe any interim changes that may have to be reversed in the further development of Phase II.

Whilst we have no objections against the accounting treatment of financial guarantees according to IAS 39 based on their economic substance and regardless of their legal form, we strongly recommend to leave credit insurance contracts in the scope of IFRS 4 on the same basis. We further recommend to review the definition of insurance contracts in Phase II because the management of insurance risk on a portfolio basis has, in our view, so far been unconsidered in IFRS 4.

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?

Hannover Re comment

We consider the proposals inappropriate. The application of IAS 37 could potentially result in a subsequent measurement of zero if the probability threshold in IAS 37 is not met. Therefore, the Exposure Draft requires to recognize the higher of the amount according to IAS 37 and the amount initially recognized less amortization.

For a credit insurance contract being scoped into IFRS 4, the probability threshold would be irrelevant due to (i) the stochastic measurement model which takes the probability of loss occurring in the expected value into account by weighting future cash flows as well as (ii) the requirement of IFRS 4 to perform a liability adequacy test at each reporting date. Therefore, in our view, no specific requirement that is not already included in IFRS 4 needs to be applied to credit insurance contracts.

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?

Hannover Re comment

In our view, the effective date and transition are inappropriate. We do not agree with a retroactive application. We believe that unnecessary disruption by forcing a change to the accounting for credit insurance prior to the finalization of Phase II should be avoided because in our understanding this undermines the spirit of Phase I and IFRS 4 (please also refer to our comment on question No. 2).

We are further of the opinion that all recognition and measurement issues related to credit insurance should be resolved in the comprehensive standard resulting from Phase II.

Disconnecting the effective date of this Exposure Draft from that of Phase II might lead credit insurers to change their accounting policies in 2005, 2006 and 2007. This fundamentally contradicts the initial commitment not to prescribe measurement principles for insurance contracts or to require changes which may need to be reversed in Phase II.

Question 5 – Other comments

Do you have any other comments on the proposal?

Hannover Re comment

In the Basis for Conclusions of the Exposure Draft, BC 25, reference is made to US GAAP, precisely to FASB Interpretation No. 45 "Guarantor´s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (FIN 45).

We consider this reference misleading because FIN 45 explicitly excludes from its scope "A guarantee (or an indemnification) that is issued by either an insurance company or a reinsurance company…" (FIN 45.6.d). With this the FASB ensures that other US GAAP pronouncements specifically governing the insurance and reinsurance accounting are not affected by FIN 45.

Although the Exposure Draft acknowledges that fact in its basis for conclusions (BC 25.d) no sufficient explanation is given for the divergent position. BC 26.c states that - unlike FIN 45 - the reason for not proposing a different treatment for financial guarantees and credit insurance is the IASB's opinion that 'distinctions based on the nature of the parties issuing a financial guarantee contract would make financial statements less relevant and reliable than distinctions (if any required) based on the nature of the transactions.'

However, we have explained in detail in our comments to the above questions that specifically the nature of the transactions and the different underlying business models are the driving criteria for a necessarily different accounting treatment of credit insurance and financial guarantees. Therefore, in our view a distinction is required in order to contribute to the clarity, comparability and reliability of financial statements.