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September 12, 2004

CL 7

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street, First Floor
London EC4M 6XH United Kingdom

Dear Sir David and Members of the Board:

Thank you for the opportunity to comment on the proposed revisions to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 4: *Insurance Contracts* regarding credit insurance and financial guarantees. On behalf of the International Accounting Standards Working Group (IASWG) of the National Association of Insurance Commissioners (NAIC), I am pleased to provide you comments in response to your Invitation to Comment.

<u>Invitation to Comment</u>

Our comments have been organized in a manner consistent with the questions outlined in the IASB's Invitation to Comment. With the release of this exposure draft, The IASWG notes that the IASB is proposing revisions to a recently released International Financial Reporting Standard (IFRS). As stated in other recently submitted comment letters, the IASWG is concerned with the recent trend of the IASB to reevaluate international standards immediately after their initial adoption and release. In accordance with this trend, we are concerned that this continued process may generate an inappropriate perception regarding the Board's deliberative process.

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.

Response:

The IASWG agrees that the substance of a transaction should primarily determine the appropriate accounting and measurement principles. However, the IASWG believes that the substance of a credit insurance contract is more similar to life, health or property insurance contracts rather than a financial guarantee. As such, the IASWG

disagrees with the proposal of the IASB to include credit insurance contracts with 'financial guarantees' and incorporate it within the scope of IAS 39. These contracts should be accounted for in a manner similar to significant insurance contract transactions.

Although the IASWG agrees that the substance of a transaction should prevail over consideration of legal form, the 'substance' of a credit insurance contract resembles the 'substance' of life, health or property insurance contracts in that payment is only required upon death, disability or other *insurable* triggering event. (Loss of collateral due to fire or theft are examples of other insurable events. Financial or credit risks are not insurable events.) Credit life insurance and credit health insurance are the types of credit insurance contracts most often written. These contracts consider mortality/morbidity or disability risks, are underwritten by licensed insurers, and allow no recourse to the insurer if the 'triggering event' occurs. Similar to other insurance contracts, the insurer is unable to dissolve or transfer the insurance contract without the consent of the policyholder except with the nonpayment of premiums. Although the insurer may obtain reinsurance to cover losses from the insurance contract, the resulting liability remains with the insurer. The only similarity between credit life/health insurance contracts and financial guarantees is that the beneficiary payment from the insurance contract equals specific debt obligations of the insured and satisfies the contractual expectations of the 'injured party'. (Unlike credit insurance contracts, a financial guarantor most often has an individual contract with the party subject to default and may seek compensation from that party if the guarantor is called to act under the contract requirements. As such, compensation from a guarantor does not eliminate the defaulter's contractual obligations.) Furthermore, the triggering event covered by the insurance contract must occur for the credit insurance coverage to be remitted.

The fundamental differences between credit insurance contracts and financial guarantees are further discussed:

<u>Mortality/Disability/Insurable Event Versus Financial Stability</u>

Credit Insurance: Credit insurance contracts are most often written as protection to lenders who fear that they will not receive full payment of established debt due to the death or disability of the debtor. Credit insurance contracts can also be written to cover potential losses to collateral property from fire, theft or other such events. In underwriting these insurance policies, issuers of credit insurance must consider the mortality and disability risk of the debtor or the property characteristics of the collateral in order to effectively price the contract. Financial stability is not a component of a credit insurance application. Furthermore, in the U.S. it is illegal for lenders to require debtors to obtain credit insurance before approving debt applications. Credit life/health insurance is identical to other health or life insurance contracts as it covers the life of an individual from death or disability. Credit property insurance is similar to property insurance contracts as it only provides payment to cover losses from theft, fire or other such risks. It is only with the existence of insurable interest in the remaining debt on noted property that the lender is entitled to be the holder and beneficiary of credit insurance contracts.

Although credit insurance contracts are written in the manner described above, credit life/health insurance contracts can also be written in a manner in which the debtor is the initiator and 'holder' of the policy. In these instances, the debtor designates the lender as the policy beneficiary. Similar to policies in which the lender is the 'holder' of the *contract, upon the debtor's death or disability the insurer would pay the lender an amount equal to the outstanding debt at the time of the triggering event. However, since the debtor is the holder, the debtor has the ability to change the beneficiary designation or to cancel the insurance policy.*

Credit property insurance is a supplemental insurance policy that is most often restricted to instances in which the debtor has failed to maintain insurance protection for an item in which the lender has interest (i.e., homeowners insurance, auto insurance, etc.) In order for the lender to collect from these policies, a triggering event must occur, and the owner must not have an insurance policy that would cover the loss. (The lender often purchases these policies when they receive notice that the owner has let insurance coverage lapse. The cost of the policy is then most often added to the owner's debt obligation.)

Financial Guarantees: Financial guarantee contracts are written for the protection of one party within a contract arrangement due to fear that the other party will fail to meet contractual obligations. When writing these contracts the independent third party primarily considers the financial stability of the applicant. The price of financial guarantee contracts is impacted by the financial well being of the party as illustrated in the issued credit ratings or credit-worthiness of the applicant. Financial guarantee contracts do not include mortality or disability factors or property insurance factors (i.e., the distance to the nearest fire station) when underwriting or pricing contracts. Furthermore, it is common for financial guarantee contracts to be a stated requirement of one of the parties within the original contract obligation.

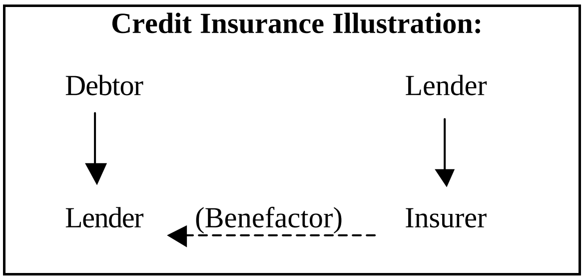
<u>Recourse of Issuer</u>

Credit Insurance: If payment is required under a credit insurance contract, the insurer has no recourse for the reimbursement of funds paid under the contract. In the case of the policyholder's death, the insurer would pay the remaining balance of the stated debt. In the case of disability the insurer would make payments towards the policyholder's debt until the policyholder was able to return to work. For credit property insurance, if the creditor's collateral (i.e., home for a real-estate mortgage) is damaged by fire, the insurer would pay the creditor the value of the lost collateral. Neither the holder of the contract, debtor, or surviving relatives would be considered liable to reimburse the funds provided under the credit insurance arrangement. The premiums paid to secure the credit insurance contract satisfied all of the responsibilities under the insurance contract.

Financial Guarantees: If payment is required under a financial guarantee, the third-party guarantor is entitled to seek reimbursement from the defaulting party. The financial guarantee was designed to ensure that one party of a contract arrangement was not financially injured if the other party failed to complete their contractual obligations. Although consideration may have been provided to obtain the financial guarantee, this expense did not dissolve the defaulter from compensating the guarantor for any funds provided under the guarantee arrangement.

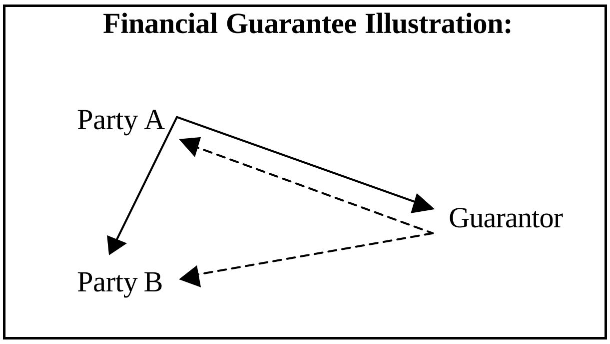
<u>Issuing Party / Contract Illustrations</u>

Credit Insurance: A licensed insurer must issue a credit insurance contract. These contracts are separate contracts from the original debtor/lender arrangement. The stated benefactor of the insurance policy is most often the lender and the amount due mirrors the outstanding debt balance at the time of the insurable triggering event. As previously stated, no recourse is permitted to the insurer for satisfying the debtor's obligations as the premium payments have already fulfilled all of the liability to the insurer.



Credit Insurance Illustration:

Financial Guarantees: A financial guarantee can be issued by any entity that agrees to compensate one party of a contractual agreement if the other party fails to act. The approval of the initial contract may be contingent on whether appropriate guarantor arrangements are needed and established. The guarantor is entitled to seek recourse from the defaulting party.



Financial Guarantee Illustration:

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?

Response:

The IASWG disagrees with the proposed revision to include credit insurance contracts within the classification of a financial guarantee contracts and require accounting and measurement under IAS 39. The IASWG proposes that all contracts meeting the IASB significant insurance contract definition be included within the scope of IFRS 4.

As a credit insurance contract includes elements consistent with other life, health or property insurance contracts, these contracts should be included within IFRS 4: *Insurance Contracts*. Only those contracts that do not subject the insurance enterprise to significant insurance risk should be considered a financial instrument under IAS 39. Furthermore, a credit insurance contract is identical to other insurance contracts with the exception that the holder is a creditor of the insured and the amount due upon the triggering event varies with a specific debt obligation of the insured. These contracts are underwritten in a manner consistent with other insurance policies in which the insured is also the holder. Given these similarities, these contracts should be included within IFRS 4.

(Please see the response to Question 1 for detail on the differences between credit insurance contracts and financial guarantees.)

By classifying credit insurance contracts within the scope of IAS 39, these insurance contracts will require initial measurement at fair value. Similar to other insurance contracts, there is not an existing market for credit insurance contracts and insurers are unable to transfer or terminate the insurance contract obligations as long as the holder remits the required premiums. (An insurer may procure reinsurance to cover losses, but reinsurance agreements do not eradicate the insurer's existing obligation.) Although the exposure draft indicates that the fair value of financial guarantees is equal to the premium received, determination of the fair value of a credit insurance policy would need to include the same considerations as the fair value of a life, health, or property insurance policy. Until the IASB has established a measurement model for insurance contract liabilities, it is inappropriate to require credit insurance contracts to be measured at an arbitrary fair value determination.

In addition to the stated differences between credit insurance contracts and financial guarantees and noted measurement concerns, this proposal will require insurers to alter the method of accounting for significant insurance contracts. As stated in IFRS 4, uncertainty (or risk) of whether an insured event will occur, when it will occur, or how much the insurer will need to pay if it occurs is the essence of an insurance contract. Credit insurance contracts have the necessary presence of risk and are considered significant insurance contracts. With the issuance of IFRS 4, insurers are in the process of making necessary adjustments to comply with the international standards. By proposing this revision separately from the phase I or phase II Insurance Contracts Project proposals, the IASB is placing an undue burden on licensed insurance companies to accommodate this revision.

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 recognized in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and (b) the amount initially recognized (i.e. fair value) less, when appropriate, cumulative amortization recognized 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?

Response:

The IASWG disagrees with the proposal to subsequently measure credit insurance contracts in accordance with the higher of IAS 37 or fair value less amortization as this method fails to consider the insurance elements within the contract.

A credit life/health insurance contract involves providing insurance on an individual whose mortality/disability risk increases in accordance with age calculations, but where the exposure to risk decreases as the policy only covers the remaining amount due on existing debt obligations. (Credit insurance policies do not cover the risk of default from financial or credit risks.) Since the premium received from the holder is calculated as an assessment of the mortality and disability risks as well as the decreasing liability of the debtor, the contract should be measured in a manner similar to other contracts that share the same considerations of insurance risk (i.e., uncertainty, mortality/disability risk).

Although the Board has compared these contracts to financial guarantees, it may be more appropriate to compare these contracts to term life insurance contracts structured to provide reduced policyholder benefits once the policyholder has surpassed specific age parameters. Regardless of how the insurance contract proceeds are used, the fundamental components of these contracts are the mortality/disability consideration coupled with a decreasing insurance benefit. To include credit life/health insurance contracts within IAS 39, and require a fair value measurement, the IASB is disregarding the underlying premise of these insurance contracts.

As a measurement model for insurance contract liabilities has not been developed by the IASB, it is premature to require credit insurance liabilities to be measured at fair value or in accordance with any calculation that stems from an initial fair value assessment. The IASWG recommends for the IASB to reiterate their previous decision and designate these contracts within the scope of IFRS 4, excluded from the scope of IAS 39, and require measurement in accordance with similar significant 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?

Response:

If this proposal was to be implemented, the IASWG disagrees with the effective date of January 1, 2006.

The IASB proposed effective date of January 1, 2006 would require insurers to implement changes to their existing systems twice within a one-year time frame to address IFRS 4 (phase I of the Insurance Contracts Project) and this proposal. Once phase II of the Insurance Contracts Project is completed, the insurers would be expected to make significant system changes again. It is impracticable for the IASB to expect insurers to continue to make system changes to address implications from the phase I standard when phase II changes are expected to produce significant system changes.

If the IASB was to proceed with this proposal, the effective date should mirror the effective date of the phase II Insurance Contracts Project. This effective date would eliminate the need for insurance companies to adjust their systems immediately after making adjustments to address components of IFRS 4. Additionally, the IASWG recommends that the Board instate a 'cooling-off' period before issuing revisions to IFRS 4 or to propose additional revisions for insurance contracts. (The IASWG recalls that this idea was discussed and supported by the IASB when discussions of the phase I Insurance Contracts Projects were occurring.)

Question 5 – Other comments
Do you have any other comments on the proposals?

Response:
The IASWG has no additional comments on the proposals except to reiterate concern regarding the recent trend to reevaluate international standards immediately after their initial adoption and release.

We appreciate the opportunity to comment on the proposed revisions to IAS 39 and IFRS 4 regarding credit insurance and financial guarantees. Should you have any questions, please contact me at (501) 371-2667, or Julie Gann (NAIC Staff) at (816) 783-8125.

Sincerely,

Mel Anderson
Chair, NAIC International Accounting Standards Working Group

Background and NAIC Process

Formed in 1871, the NAIC is a voluntary organization of the chief insurance regulatory officials of the 50 states of the United States of America, the District of Columbia, American Samoa, Guam, Puerto Rico and the Virgin Islands. The mission of the NAIC is to assist state insurance regulators, individually and collectively, in serving the public interest in a responsive, efficient and cost-effective manner, consistent with the objectives of its members.

In fulfilling this mission, the NAIC has developed significant experience and expertise in the development of meaningful accounting principles for use in the financial statements of insurance enterprises. The NAIC has the responsibility to establish and interpret statutory accounting principles. The codification of statutory accounting principles by the NAIC produced a comprehensive guide for use by insurance departments, insurers, and auditors.

The fundamental concepts upon which these principles were promulgated are conservatism, consistency and recognition. While these principles are not identical to the framework used by the IASB, which govern general-purpose financial statements, the NAIC has developed expertise with general-purpose financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). The NAIC reviews all U.S. GAAP pronouncements to determine their relevance for statutory accounting purposes.

These comments have been prepared by the IASWG of the NAIC. As part of the NAIC's due process procedures, these comments have also been shared with interested parties to the IASWG, all of whom were given an opportunity to contribute to the IASWG's deliberations of these issues. However, the IASWG does not wish to imply that these comments are shared by all of the IASWG interested parties.