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Ref.: **Comment letter by the Allianz Group on ED of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts: credit insurance and financial guarantees**

Dear Sir David,
Ladies and Gentlemen,

the Allianz Group appreciates the opportunity to comment on the IASB's proposals to account for financial guarantees and credit insurance. Whilst we are supportive of the IASB's view that similar financial products with different legal form should be accounted for in the same way, we believe that, although credit insurance and financial guarantee contracts share many similarities, they are different not only in legal form but also in economic substance. We are therefore of the opinion that these economic differences should be reflected accurately in the accounts.

In our view credit insurance is an insurance product. Credit insurance has similar characteristics to other insurance products, notably P&C business, and should be accounted for in the same way as other insurance products under IFRS 4. We believe that unnecessary disruption to credit insurers' accounting prior to Phase II should be avoided. Indeed the IASB has committed itself when developing IFRS 4 to limit interim changes for insurance contracts while the subject is under review. The present Exposure Draft introduces material changes which should not predetermine the developments in Phase II.

We do not understand why for one specific type of insurance product measurement rules in accordance with IAS 37 and 39 are prescribed prior to Phase II. Furthermore, IAS 37 and 39 do not provide sufficient guidance on the measurement of insurance contracts. We are therefore of the opinion that all recognition and measurement issues related to credit insurance should be resolved in the comprehensive standard on insurance contracts resulting from Phase II. A final decision on how this kind of business is accounted for under IFRS should be made for credit insurance in the same way and at the same time as for all other lines of insurance business.

We consider the fact that the IASB confirms that credit insurance contracts meet the definition of insurance contracts, whilst at the same time concludes that these contracts also meet the definition of a financial guarantee and should therefore be accounted for according IAS 37 and 39 as highly inconsistent and do not regard the arguments for an exclusion from the scope of IFRS 4 as valid.

Furthermore, the proposals in the present ED are contrary to the objective of convergence with US GAAP, where insurance and reinsurance accounting is not affected by FIN 45 that deals with accouting for financial guarantees.

More specifically, our answers to the questions set out in the Exposure Draft are 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, 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.

We support the general principle set forth by the IASB Framework that the legal form of contracts should not determine the accounting treatment (economic substance over legal form). However, from our point of view it is not the legal form which creates the differences but the economics standing behind the contracts. The following is evidence of economic differences between financial guarantees and insurance against credit risk:

- In general, financial guarantees in the banking business are entered into by the party whose obligation shall be guaranteed, hence the contract-partner of the bank is the debtor and is therefore legally different from the beneficiary (the beneficiary is not directly involved in closing the contract); whereas, insurance against credit risk is entered into by the seller of goods and protects the seller against default by the buyer (debtor), hence the holder and the beneficiary are legally identical.

- The default under financial guarantees are partly under the control of the holder / debtor, who can make an arbitrage between defaulting under the terms of the financial guarantee or issuing another debt instrument; whereas, insurance against credit risk is not subject to moral hazard as the default is outside the control of the holder.

- Financial guarantees might be settled through a loan to the holder and are managed as loan commitments by the issuer; whereas, insurance against credit risk is settled through an insurance indemnity paid to the holder. Hence, financial guarantees cover pure financial risk and no significant insurance risk. Therefore, independently from the legal form, the proposed definition for a financial guarantee is not in line with the definition of an insurance contract

- Credit insurance usually also includes extensive service features, as for example, cash management and management support in avoiding claims and insolvency. In that way it is different in substance to a financial guarantee which is principally only providing the pure guarantee service.

As a solution and an alternative to the IASB's proposals we suggest an alternative definition of a financial guarantee. It aims to draw a line between credit insurance contracts that would be scoped in IFRS 4 and those financial guarantees that are managed as loan commitments that would be in the scope of IAS 39.

Alternative definition of a financial guarantee:

> "A financial guarantee contract is a contract that
>
> **(i)** 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 and
>
> **(ii)** **the nature of which is comparable to a loan commitment as it is settled through a loan to the party whose obligation is being guaranteed in the event of an adverse effect.**
>
> **Those financial guarantee contracts meeting the criteria in (i) but not in (ii) are in the scope of IFRS 4 as they are insurance contracts."**

Question 2 – Is the proposed scope appropriate ?

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 regard the proposed scope as appropriate. To the extent that credit insurance contracts transfer significant insurance risk, they clearly meet the definition of insurance contracts and should be scoped in IFRS 4. Whether a contractually specified future event will occur is as uncertain as the number of possible claims at the date of inception of the contract.

A further consequence of the proposal to scope credit insurance contracts into IAS 39 would be that with respect to disclosure, the requirements in IAS 32 would become mandatory. However, IAS 32 lacks specific guidance on the disclosure of insurance risk information such as for example the guidance provided in IFRS 4 to disclose claims development tables.

In our view, guidance on specific insurance features can only be given in IFRS 4 and not in IAS 37 and 39.

We consider the fact that the IASB confirms that credit insurance contracts meet the definition of insurance contracts, whilst at the same time concludes that these contracts also meet the definition of a financial guarantee and should therefore be accounted for according IAS 37 and 39 as highly inconsistent and do not regard the arguments for an exclusion from the scope of IFRS 4 as valid.

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?

We do not regard the proposals as appropriate.

We believe IAS 37 does not provide sufficient guidance on the measurement of insurance features. In fact, the IASB itself sees the necessity to develop a more comprehensive accounting standard for insurance contract accounting as the current guidance provided by existing IFRS is regarded as insufficient.

Deviating from current practice, the measurement in accordance with IAS 37 would have to consider the time value of money, which might or might not be different from the notional amount due to the business being short term. However, if insurance against credit risk is scoped in IAS 37 and 39, credit insurers will need to find interpretations on how to measure the insurance features under IAS 37. Different interpretations from preparers and/or auditors will potentially lead to discrepancies in the published financial statements of credit insurers, endangering reasonable comparisons amongst competitors by external parties.

We regard the guidance in IFRS 4 as sufficient until a comprehensive standard on accounting for insurance contracts will be completed. In particular, it should be noted that IFRS 4 requires an insurer to perform a liability adequacy test and to assess at each reporting date whether its recognised liabilities are adequate using estimates of future cash flows.

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?

Should this Exposure Draft be applied, we consider its effective date inappropriate.

The proposed effective date might lead credit insurers to change their accounting principles in 2005, 2006 and 2007 (Phase II). We believe this would not meet the objective of making our financial statements understandable and comparable to external parties.

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. Furthermore we do not agree with the proposed retroactive application.

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

- The proposals in the present ED are contrary to the objective of convergence. The FASB Interpretation No. 45 "Guarantor´s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (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 ED 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, in this comment letter we have explained that it is mainly the nature of the transaction that is different between credit insurance and financial guarantees which requires a different accounting treatment in order to contribute to the clarity, comparability and reliability of financial statements.

- Similarly to IFRS 4, the present Exposure Draft does not address accounting by the holder of a financial guarantee contract. From our point of view this is not systematic, since it proposes to scope both credit insurance and financial guarantee contracts into IAS 39 which provides detailed guidance for both, the holder and the issuer. From our point of view this inconsistency is another indication that the proposed change in scope within the ED is counter-intuitive and that insurance against credit risk should be scoped into IFRS 4.

We would be pleased to discuss our comments with you.

Yours sincerely,

Dr. Helmut Perlet
Member of the Management Board
and Chief Financial Officer

Dr. Susanne Kanngiesser
Head of Group Accounting