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Dear Mrs. Pryde,

Amendments to IAS 39 and IFRS 4
Exposure Draft "Financial guarantee contracts and insurance contracts"

We are pleased to meet your request concerning comments on the proposed amendments to IAS 39. We would like to start with some general introductory remarks followed by answers to the individual questions.

General remarks

We share the opinion of the Board that the legal form of a transaction should not be decisive for the applicable accounting rule. However, from our point of view financial guarantees and credit insurance contracts may not only differ in terms of their legal form but also – and mainly – with regard to their economic substance, as we will explain below in answer to your questions. These differences should be taken into consideration in accounting rules that best reflect the economic substance. For this reason, credit insurance contracts that contain the same features as all other insurance contracts should be accounted for under the same accounting rules as insurance contracts (IFRS4 or Phase II) whereas financial guarantees that only imply financial aspects such as loans or loan commitments, should be accounted for under IAS 39.
Moreover, we think that there should be no amendment to insurance products before Phase II is completed. When discussing and adopting IFRS4, the Board agreed to making only marginal changes with the objective of solving all the aspects concerning insurance contracts in Phase II. Bearing this in mind, the accounting of credit insurance contracts should be resolved at the same time and under the same IFRS as is the case with all other insurance contracts.

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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:

We agree that the legal form of contracts should not affect their accounting treatment (substance over form). Therefore, economic differences should be taken into account. From our point of view, financial guarantee contracts and credit insurance contracts are not synonymous. The main differences in our view are as follows:

- Financial guarantees deal with specific exposures whereas credit insurance contracts cover overall turnover, regardless of the number of counter-parties involved. In this way, credit insurance covers a group of risks within a contract with one customer, whereas a financial guarantee given by a bank does not.
- Credit insurance contracts include features, such as deductibles, percentage of coverage and maximum liability that are typical for credit insurance but not for financial guarantees issued by banks.

There are many other economic differences. Admittedly, depending on the type of contract issued by the bank, these differences may be small or even balance each other out. In the following you will find some examples of differences between financial guarantees provided by banks or other enterprises and credit insurance contracts issued by insurance companies:

- Financial guarantees are usually arranged at the request of the party whose obligation is to be guaranteed, whereas a credit insurance contract is concluded by the creditor

- Financial guarantees issued by banks are based on the assessment of a company's credit-worthiness (= assessing the occurrence of an adverse event) whereas credit insurance insures the credit component of the risk of selling (assessing the occurrence of an adverse event + probability that the insured will incur a loss)

- Financial guarantees by banks are comparable with loans, the only difference being that there is no cash flow. Often, financial guarantees are collateralised. In case of a loss, the collateral is sold in order to mitigate the loss. Credit insurance companies hardly ever have collateral. They are, however, subrogated and become unsecured creditors.

- If a bank issues a financial guarantee, it generally does not provide any other services, whereas credit insurance contracts are usually combined with services such as assessment and collection.

These differences show that economically speaking a financial guarantee issued by a bank is not the same as a credit insurance contract for the issuer or the holder.
The economic differences should be allowed for in different accounting methods.

We think that it would be much more important and consistent to disclose the economic issues in the financial statements in the same way rather than to treat credit insurance contracts and financial guarantees in an identical manner, since they do not have much in common in terms of their economic background and management.

Many specific features of a credit insurance contract, e.g. acquisition costs, reinsurance accounting and renewal options, are not covered by IAS39/37, whereas they are covered by IFRS4. We do not see a reasonable justification for the requirement to account for an insurance contract as defined in IFRS4, under IAS39/37. In our opinion this is highly inconsistent.

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:
In our opinion, the scope is not appropriate because it aims to absorb a specific form of insurance contract (here: credit insurance). As outlined in the answer to question 1, a credit insurance contract is not a financial guarantee, such as those provided by banks. Financial guarantees, which are comparable to loans, should be dealt with under IAS39/37, whereas insurance contracts as defined by IFRS4, should be accounted for under IFRS4, regardless of the risk involved.

The scope should therefore be changed in a way that it clarifies that only financial guarantees comparable to financial instruments are under IAS39 but not contracts that meet the definition of an insurance contract as codified in IFRS4.

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?

Response:

Subsequent measurement may be appropriate for financial guarantees comparable to loans. It is not appropriate for insurance contracts (see answers to question 1 and 2).

The objective of the Board is to ensure that financial guarantees are shown on the balance sheet and not only off-balance (BC7, BC22), to which we agree. Nevertheless, no new rules are needed for credit insurance contracts, as they are already shown on the liabilities side under IFRS4: on the one hand, as unearned premiums and on the other as IBNR. The liability adequacy test ensures that the liability is accounted for at the appropriate value. Even the Board states that application of IAS39/37 will have only slight effects on the results. We therefore do not see any need for changing a method that is known and accepted – and understandable to the balance sheet reader – to a method which raises many questions (see above and also as regards how to measure insurance features under IAS37) and forces the companies to reorganise their accounting and valuation.
Moreover, in our opinion, the proposed accounting method will lead to confusion as a typical insurance transaction should be disclosed as a "financial instrument" and therefore simply as a "liability" whereas all other insurance contracts are disclosed as "gross underwriting provisions". We do not believe this supports the objective of a "true and fair view" or consistent reporting.

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:

Supposing the amendments are adopted in spite of all the arguments against them, we regard the effective date and transition as inappropriate. Insurance companies will have to consider changes in the accounting methods of insurance contracts in 2005 (IFRS4), 2006 (amendment IAS39) and when Phase II becomes effective. We do not think this will make our annual reports more understandable, therefore such an amendment should not be detached from the effective date of Phase II.

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

Response:
In our understanding that the proposals are meant to minimise the differences between IFRS and US GAAP. Under US GAAP financial guarantees are governed by FIN 45. Credit insurance contracts are explicitly exempted from FIN 45 and have to be accounted for under specific statements to insurance companies. The Board did not follow the accounting rules in US GAAP but chose another way that is “more relevant and reliable” in their opinion. As we demonstrated above, the accounting method chosen by the IASB will lead to less reliable financial statements, because it discounts the obvious economic differences between financial guarantees and credit insurance contracts.

Taking into account our comments, we ask you to reconsider the ED in respect of credit insurance contracts, which are not comparable with financial guarantees and should therefore be accounted for under IFRS4, as is the case with all the other insurance contracts.

We would be pleased to discuss our comments with you if this is of assistance.

Yours sincerely

Münchener Rückversicherungs-Gesellschaft

gez. Pfaller gez. Hörmann