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N° 613

PARIS, 8TH OCTOBER 2004

CL 41

Sir David Tweedie

IASB

30 Cannon Street

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UNITED KINGDOM

Re: Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments *Recognition and Measurement* and IFRS 4 *Insurance Contracts*: *Financial Guarantee Contracts and Credit Insurance*

Dear David,

The Conseil National de la Comptabilité (CNC) examined carefully the Exposure Draft on financial guarantee contracts and credit insurance. These comments result from a working group including participants from insurance companies, banking institutions, audit firms and supervisory authorities. The detailed answers to IASB's questions are attached herewith.

As already stated in our comments on ED 5 *Insurance contracts*[1] and on the draft IFRS 4 standard[2], genuine activities of credit insurance, which meet the definition of insurance contracts, have to be covered by IFRS 4 *Insurance contracts*, as insurance contracts contain specific features which imply specific accounting treatments.

The Exposure Draft gives a proposed definition of "financial guarantee contracts" which does not attempt to make a difference between credit insurance and financial guarantees, although they are fundamentally different in substance.

While we share the IASB's objective to amend the measurement of financial guarantees for the reasons stated notably in BC13, we consider that the proposed Exposure Draft does not appropriately reach the aimed objective.

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[1] Our letter dated October 29, 2003

[2] Our e-mail to Peter Clark dated February 10, 2004

We stress that the definition of “financial guarantee contracts” has to be further developed in order to acknowledge that economic differences should lead to different accounting treatments.

Although both deal with credit risk, there are fundamental differences in substance between credit insurance and financial guarantees :

- The issuer of a credit insurance gives a protection to his client with regard to receivables held by this client in the course of his business whereas the issuer of a financial guarantee is co-debtor with his client vis-a-vis a third party who finally benefits from the guarantee issued (ie the issuer of a financial guarantee has to redeem the liability instead of his client to the third party).
- The issuer of a credit insurance does not know either the existing receivables nor the future ones whereas the issuer of a financial guarantee bases its decision on the credit risk analysis of a specified client.
- The issuer of a credit insurance has a portfolio approach whereas the issuer of a financial guarantee has an individual client approach.
- As a consequence, the issuer of a credit insurance mostly manages insurance in a credit risk environment whereas the issuer of a financial guarantee manages only **a** credit risk.

We stress that these economic differences should lead to different accounting treatments: financial guarantees are very close to credit commitments and, as such, should be in the scope of IAS 39 whereas credit insurance contracts (if insurance risk is significant) are insurance contracts and should stay in the scope of IFRS 4.

The definition of a “financial guarantee contract” should be reviewed in order to clearly limit the scope of IAS 39 / 37 to financial guarantees in their economic definition, ie products which are close to credit commitments and do not meet the definition of an insurance contract. Although one could understand that credit insurance does not meet the proposed definition, as there is no ”specified debtor”, we stress that this difference between credit insurance and financial guarantees has to be clearly stated and all consequences of this position be dealt with.

While reminding that the main objective of the Exposure Draft relates to improving measurement, we stress that the proposed provisions are closely linked to the definition of a financial guarantee: if the definition was improved, as proposed above, the measurement of financial guarantees would only have to refer to IAS 39’s provisions for a commitment to provide a loan at a below-market interest rate . Namely, paragraph 2(h) already states that the issuer of such a loan commitment “shall initially recognise it at fair value, and subsequently measure it at the higher of (i) the amount recognised under IAS 37 and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18”.

For credit insurance, the basis for conclusions § BC23 acknowledge that the proposed requirements are very similar to the existing accounting models and thus would not bring any improvement.

Consequently, we firmly believe that the proposed requirements are less relevant than IFRS 4 provisions, as IFRS 4 temporarily allows entities to continue existing practices. If issuers of credit insurance should not benefit from the temporary exemption granted by IFRS 4, being outside the scope of this standard but in the scope of IAS 39 and IAS 37, they would have to develop new accounting practices for many specific items such as performance features, reinsurance and acquisition costs, in order to comply with IAS 8 and possibly would have to reconsider them once Phase II is being implemented.

Overall, we consider that the Exposure Draft does not contribute to improving existing standards and has to be fundamentally revised.

Should you need any further information, do not hesitate to contact me.

Yours sincerely,

Antoine BRACCHI

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.

CNC comments

We agree that differences in the legal form should not lead to differences in the accounting treatment.

However, we would like to stress that differences in the economic substance could lead to differences in the accounting treatment and that there are actually significant economic differences between credit insurance and financial guarantees.

Although both deal with credit risk, the main differences in substance between credit insurance and financial guarantees are the following:

The economic nature of the relationship to the client, and even the economic nature of the client, is different for the issuer of either a financial guarantee or a credit insurer.

- The issuer of a financial guarantee is co-debtor with his client vis-à-vis a third party who finally benefits from the guarantee issued (ie the issuer of a financial guarantee has to redeem the liability instead of his client to the third party) :
  - The client benefits thus from a better credit rating because of the guarantee received.
  - The client is a debtor towards a third party and will generally become a debtor of the issuer of the financial guarantee, should the credit risk occur (ie if he fails to fulfil his obligation).
  - Namely the issuer of a financial guarantee will pay the third party, which otherwise would suffer a loss, and ask his client for reimbursement, generally issuing a loan subject to interest revenue.
- The issuer of a credit insurance gives a protection to his client with regard to receivables held by this client in the course of his business :
  - The own credit risk of the client remains unchanged after the issuance of the guarantee. The only change relates to the credit risk supported by the client on its portfolio of receivables which has been reduced.
  - The client is a creditor with a portfolio of receivables and will never become a debtor towards the credit insurer.
  - Namely the issuer of a credit insurance will indemnify his client for the loss it incurred and try to recover from the defaulting customer.

It should be underlined that these differences in products are not necessarily identical to differences in the main activity of the issuer: notably, financial guarantees may be issued by insurers or financial guarantees issued by banks could meet the IFRS definition of an insurance contract.

This difference in the economic nature of the client drives the way operations are priced and managed.

- At inception, the issuer of a credit insurance has a portfolio approach whereas the issuer of a financial guarantee has a client by client approach.

The issuer of a credit insurance gives a protection to his client with regard to a specified portfolio of receivables. The receivables contained in this portfolio will change with the course of time: consequently, the issuer of a credit insurance does not know exactly who the debtors are.

The issuer of a financial guarantee has generally a direct contact with the client who is the debtor or in any case will get a recourse against him through legal mecanisms.

  - A credit insurer bases his decision on a portfolio analysis of receivables held by his specified client without knowing which will be the identity of the different customers.
  - The issuer of a financial guarantee bases its decision on the credit risk analysis of a specified client and would never cover a debtor known as being ailing.

- This portfolio approach is also used for subsequent measurement by issuers of credit insurance whereas issuers of financial guarantees have mostly a line by line approach.

As a consequence, we stress that these economic differences should lead to different accounting treatments : financial guarantees are very close to credit commitments and, as such, should be in the scope of IAS 39 whereas credit insurance contracts (if insurance risk is significant) are insurance contracts and should stay in the scope of IFRS4.

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?

CNC comments

We find the proposed definition inappropriate.

As already stated above, we consider that the creation of a unique definition for products, which are of different economic natures, is inappropriate.

Besides, we would like to underline that one could understand that credit insurance does not meet the definition of a “financial guarantee contracts”: actually, in a credit insurance contract there is no ”specified debtor”. As detailed above, the issuer of a credit insurance gives a protection to his client with regard to the existing receivables but also to the future receivables: the issuer of a credit insurance does not know either the existing debtors nor the future ones. As a consequence, the debtor cannot be specified. Should that understanding be accurate, we stress that the IASB has to state it very precisely as it appears very unclear in the present ED’s wording.

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?

CNC comments

While sharing IASB’s concern that measurement of financial guarantees should not lead to the immediate recognition of profit, we do not see the proposals as appropriate for mainly four reasons :

The existing requirements in IFRS 4 already provide appropriate requirements for credit insurance contracts

We do not see the rationale for scoping these contracts out of IFRS 4: beyond the issues raised above with regard to the definition, the proposed measurement would bring no real improvement to the existing practice in IFRS 4.

As stated in IFRS 4, the requirement of a liability adequacy test with reference to IAS 37 aims at avoiding that “material and reasonably foreseeable losses arising from existing contractual obligations” are not recognised[3]. As this requirement appears to be satisfactory for every kind of insurance contract, we do not see why it could not be also the case for credit insurance. If it were however the opinion of the Board, we suggest including an amendment in IFRS 4 without scoping the contracts out of it.

[3] IFRS4 BC94-95

The proposed requirements are less relevant for credit insurance contracts than the existing accounting standards and could reduce (instead of increasing) the comparability between entities

As stated in IFRS 4, the main objectives for phase I were to make limited improvements to existing accounting practices before several practical and conceptual issues are investigated in phase II.

Should credit insurance be scoped in IAS 39, issuers of these contracts would have to develop accounting practices if no IFRS applies to an item[4]. That would be especially the case for many specific items such as performance features, reinsurance, acquisition costs or salvage and recoveries, some of which are to be examined in phase II of the IASB insurance project.

Reinsurance would be a difficult issue as it should not meet the IFRS 4 definition and thus compel entities to develop accounting practices from standards that do not consider this specific topic.

If so, different entities would have to develop different accounting treatments whereas the continuation of existing practices according to IFRS 4 would allow to maintain comparability between them.

The proposed measurement of financial guarantees could be easily achieved through a single amendment to the existing IFRSs, should the definition of a financial guarantee be reviewed

Financial guarantees are very close to credit commitments for mainly two reasons : (a) should a credit risk occur, they would generally lead to a credit risk towards the debtor (b) they are fully part of the core business of the lending activity.

Some loan commitments[5] are in the scope of IAS 39 and § 2(h) states that the issuer of such a loan commitment "shall initially recognise it at fair value, and subsequently measure it at the higher of (i) the amount recognised under IAS 37 and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18".

Example 9 of IAS 37 also gives already information about the accounting treatment of such a guarantee : referring to § 14 and 23 of IAS 37, it states that a present obligation has to be recognised and "measured at the higher of (a) the best estimate of the obligation and (b) the amount initially recognised less, when appropriate, cumulative amortisation in accordance with IAS 18 Revenue".

Consequently, we do not see any need for many amendments of existing standards to achieve the intended objective. The definition of financial guarantees having been reviewed (cf question 1 and 2), we believe that it could be appropriate to add a single paragraph in IAS 39, stating the requirement to account for financial guarantees as for those loan commitments that are already measured as intended.

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[4] IFRS 4 BC 77 : Paragraphs 10-12 of IAS 8 specify a hierarchy of criteria that an entity should use in developing an accounting policy if no IFRS applies specifically to an item. Without changes made in the IFRS, an insurer adopting IFRSs in 2005 would have needed to assess whether its accounting policies for insurance contracts comply with these requirements. In the absence of guidance, there might have been uncertainty about what would be acceptable. Establishing what would be acceptable could have been costly and some insurers might have made major changes in 2005 followed by further significant changes in phase II.

[5] Ie « Commitments to provide a loan at a below-market interest rate »

The proposed requirements will not allow a consistent measurement of financial guarantees and credit insurance

The proposed Exposure Draft highlighted the fact that some financial guarantees were scoped under IFRS 4 (should they contain a significant insurance risk). Consequently, there should not be any concern any longer that the issuers of such financial guarantees may miss the IFRS 4 measurement requirements.

It should also be underlined that the measurement in IAS 37 of both financial guarantees and credit insurance will not bring a greater consistency for those two kinds of products. Actually, as IAS 37 allows both a line by line measurement and a portfolio approach, we presume that the first approach would be used by issuers of financial guarantees and the second one by issuers of credit insurance (who cannot practically have a line by line approach as they do not know in advance the defaulting debtors).

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?

CNC comments

Should the Exposure Draft be accepted, we stress that the application in 2006 would introduce huge and spurious successive changes in the reporting format especially for the credit insurance sector as far as IFRS 4 will have to be applied in the meantime. For first applicants, and should the insurance project phase II bring new amendments, there would be 3 different ways of reporting in a very short period which is time consuming and very badly accepted by users.

Question 5 – Other comments

Do you have any other comments on the proposal?

CNC comments

We noted some discrepancies between the general purpose of the Exposure Draft and the way it is drafted. Whereas the Exposure Draft aims at clarifying that all entities that issue financial guarantees should recognise a liability at inception, it mainly focuses on credit insurance contracts which already give rise to such a recognition at inception.

The Exposure Draft should principally deal with financial guarantees that are close to credit commitments and do not meet the definition of an insurance contract.

For illustration purposes, we particularly noted the following :

- In IN1, it is stated that financial guarantee contracts are sometimes known as "credit insurance": it has to be stressed that credit insurance is only one possible form of the proposed definition of a financial guarantee contract[6].
- The Exposure Draft appears to aim at improving accounting principles for financial guarantee contracts that meet the definition of an insurance contract[7] whereas the Exposure Draft also states that the proposed requirements would, in most areas, not change the existing accounting models for insurers (cf § BC23). This presentation is unclear and does not seem to be in accordance with the otherwise declared objective to "rectify the underlying recognition problem with IAS 37"[8]. Namely, the statement made in BC13 about the measurement at nil of a liability in IAS 37 after initial recognition could not apply to an insurance contract. Actually, IAS 37 requires a present obligation to be more likely than not whereas IFRS 4 states that insurance risk is significant if an insured event could cause an insurer to pay significant additional benefits in any scenario[9]. It implies that the solution proposed in BC14 could not be aimed at insurance contracts but at other financial guarantees.

[6] IN1 These contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract.

[7] BC17. The Board decided to publish this Exposure Draft for the reasons in paragraph BC16(d).

BC16(d) : Unless (c) applies, the measurement described in the revision of IAS 39 of December 2003 (see paragraph BC14) is appropriate for a financial guarantee contract that meets the definition of an insurance contract. However, the Board acknowledged the need to expose this conclusion for comment. Mindful of the need to develop a 'stable platform' of Standards for 2005, the Board decided to finalise IFRS 4 without specifying the accounting for these contracts and to develop this Exposure Draft. Pending amendments resulting from this Exposure Draft, IFRS 4 treats these contracts in the same way as other insurance contracts (as proposed in ED 5).

[8] Information for observers – Proposed amendments to IAS 37 (September 24, 2004)

[9] IFRS4 B23 « the condition in the previous sentence may be met even if the insured event is extremely unlikely »