



ASSOCIATION ACTUARIELLE INTERNATIONALE INTERNATIONAL ACTUARIAL ASSOCIATION

13 October 2004

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

Dear Sir David,

**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**

In response to the request for comments to the above Exposure Draft, I am pleased to transmit on behalf of the International Actuarial Association (IAA) our comments and recommendations.

To summarize our principle comments, the IAA believes that:

- The proposed definition of a financial guarantee contract includes within its scope many insurance contracts that are similar in many respects to contracts being studied in the current IASB project on insurance contracts. We do not believe that the proposed definition is appropriate and believe that IFRS 4 should continue to apply, at least until the current insurance project is complete.
- Since the measurement of both insurance contracts and financial instruments are being studied by the IASB working groups, it is premature to change the accounting for these contracts now, since these reviews will likely lead to further changes in accounting treatment for them in a couple of years.
- The ED's Basis for Conclusion does not present a sufficient argument for a new accounting treatment for these contracts now, particularly for those that would have been insurance contracts other than for the carve-out. Nor does it provide substantive guidance for many of the issues currently under study by the IASB regarding insurance contracts, such as treatment of renewal premiums, and could introduce inconsistency in financial results between directly written and ceded reinsurance contracts.

These comments have been prepared by a committee of the IAA, the members of which are listed by name and association in the Appendix to this submission. The IAA member associations are also listed in the Appendix.

Yours sincerely,

Yves Guérard
Secretary General

Attachment: IAA comments

IAA Comments on the IASB's Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts – Financial Guarantee Contracts and Credit Insurance

THE INTERNATIONAL ACTUARIAL ASSOCIATION

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our fifty Full Member actuarial associations encompass more than 95% of all actuaries practicing around the world. The IAA promotes high standards of actuarial professionalism around the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within, or likely to have an impact upon, the areas of expertise of actuaries.

We are not a trade association and do not represent the interests of either clients or employers. As actuaries, we have developed significant experience and expertise in the assessment of the value of contingent cash flows. Using this experience, actuaries will, as a profession, continue to provide assistance to those involved in the enhancement of financial reporting standards to make them more useful to the users of financial statements.

The IAA, together with other interested parties, appreciates this opportunity to provide input to the IASB regarding its proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 4 *Insurance Contracts – Financial Guarantee Contracts and Credit Insurance*. We commend the IASB for addressing this relevant financial reporting issue.

These comments have been prepared by the Insurance Accounting Committee of the IAA, the members of whom are listed by name and association in the Appendix to this brief. The Full Member associations of the IAA are also listed in the Appendix.

IAA COMMENTS

General observations

While we agree that the form of a contract should not affect their accounting treatment, we also believe that otherwise identical insurance contracts should be treated in a similar manner. As a result, we are uncomfortable with the definition of a financial guarantee contract given in the proposed amendment to IAS 39. It covers a wide array of contracts, from guarantee insurance to a letter of credit. In some cases, even contracts which would be, other than the proposed carve-out, insurance (e.g., credit life and disability) might be seen as falling within the definition, e.g. if the contract includes reference to failure of payment caused by death or disability. However, any form of insurance whose beneficiary is a lender which provides compensation when the specified debtor fails to make a payment when due as a result of these insured events would be included. The proposal introduces an inconsistent accounting treatment for otherwise identical insurance contracts.

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If this ED was adopted, a mortgage term life insurance contract or in certain countries an endowment contract that pays off a loan to the lender upon the death or disability of a debtor would be considered to be a financial guarantee contract. The identical life insurance contract whose beneficiary is the family or estate of the insured would be considered as insurance, and would as a result be given inconsistent accounting treatment.

In fact, the summary of the recent accounting history of these contracts given in the Basis for Conclusion convinces us that a separate measurement for non-insurance financial guarantee contracts and insurance contracts is preferable. In fact, significant issues involved in the accounting treatment for the latter contracts in absence of conclusions regarding identical or similar insurance contracts offered to other beneficiaries, such as the determination of the proper treatment for renewal premiums that exist in many of these insurance contracts and the measurement of the risk margin referred to in IAS 37 that would also apply to these contracts. We believe, as indicated in our response to question 1, that accounting measurement for similar contracts with similar risks should be treated in a consistent manner.

Contracts that pay on default contain most, if not all, of the necessary characteristics of insurance and should continue to fall within the IFRS 4 exemption from the IAS 8 hierarchy. The exposure draft proposes to place financial guarantees under IAS 39, but as a result introduces a measurement approach that is neither fair value nor amortized cost as must be applied to all other financial liabilities. The discussion provided does not convincingly show that such a measurement basis is either more relevant or more reliable than the current approach. Given the direction that the Board appears to be taking, it would seem to be preferable to defer consideration of this proposal until acceptable measurement approach for insurance to be developed.

In some insurance contracts, notably surety contracts, the credit guarantee is part of a broader performance guarantee. Surety contracts would meet the definition of financial guarantees in most cases and the measurement of fair value for such contracts is likely to be inconsistently applied and misinterpreted. Many surety contracts are protected by pledged collateral in a wide range of forms and these contracts also give the insurance company broad and preferential rights that would be quite difficult to measure. For example, a surety can step in the shoes of a contractor under certain circumstances that are not strictly a default. A failure to perform under a construction contract could trigger the construction project owner to exercise its contractual rights to collect compensation from the contractor. However, the contractor has a performance obligation, not a payment obligation. If the contractor fails to perform, the liability for compensation to complete the project is guaranteed by the surety. We do not believe that IAS 39 adequately addresses such broader guarantees and that the provisions of IFRS 4 should be applied.

In addition, the implementation of this proposed amendment in 2006 may, depending on the outcome of the current IASB insurance contract and financial instrument projects,

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may subsequently have to be changed again upon completion of these two projects. Note that the presumption in BC16(e) that a default fair value is zero is contentious and appears to ignore how prices are set in many of the marketplaces involved. As a consequence of pooling a large number of independent and homogenous exposures, the overall risk can be reduced significantly. Therefore, the value of such coverage from the policyholders' view is significantly greater than from insurer's view, which considers the individual contract as an integral part of a pool. .

In addition, since the accounting treatment for the holder of such a contract is not addressed, an insurer who has ceded a block of this business to a reinsurer might measure its insurance assets (the reinsurance ceded business) inconsistently from the underlying liability, which we believe would result in potentially misleading financial results.

As a result of these issues, we recommend that this ED be deferred and taken up in conjunction with the insurance contract phase II and financial instrument projects.

Specific ED Questions

Our responses to the specific questions raised in the ED follow:

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.

IAA Response: Yes, we agree that the legal form of contracts should not affect their accounting treatment. In addition, we agree with the principle that the substance of a transaction or contract should determine its measurement approach. Nevertheless, since (1) the proposed definition of financial guarantee contracts will encompass many insurance contracts which are identical or quite similar to other insurance contracts that fall in the scope of IFRS 4 and (2) we believe that identical or similar contracts covering the identical risks should be provided identical accounting

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treatment, inconsistent accounting treatment will result within many insurers from the adoption of this ED.

We therefore fail to understand why this change is being made when the accounting treatment for other insurance contracts has been deferred to phase II. We are not currently convinced that the proposed treatment here will be consistent with the eventual outcome of the two IASB projects. We do not believe it to be desirable to introduce inconsistencies in treatment among insurance contracts offered by insurers at this time, possibly to have to change this treatment when phase II is completed.

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?

IAA Response: No, it is not appropriate – see the IAA response to Q1 above, as the scope sweeps in too many insurance contracts.

We believe that the proposal to make the measurement of all financial guarantees consistent with similar insurance contracts is ultimately appropriate. The ED indicates that the substance of many financial guarantee contracts is an exposure to credit risk. Unfortunately, many contracts that would be included in the current definition of financial guarantees more closely relate to their underlying insurance exposures, and are thus more consistent with an insurance model, which is properly being addressed in a separate project.

This issue may be particularly acute for surety performance bonds, due to an ambiguity in the definition of financial guarantee in proposed paragraph 9. That paragraph defines a financial guarantee as being based on failure to perform on a debt instrument, but does not define the term “debt instrument.” Could “debt instrument” include a penalty triggered by failure to complete a construction project or other service? Could it include sales tax payments that failed to be forwarded to a governmental entity? Many of these bonds may also be satisfied by compelling performance or by stepping into the shoes of the party required to perform, even if that party has yet to technically default in their performance. We do not believe that

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IAS 39 adequately addresses such broader guarantees and that the provisions of IFRS 4 should be applied.

In addition, inconsistencies exist between the various standards in the operation of the scope paragraphs. For example, the Exposure Draft proposes that the measurement of all insurance contracts that meet the definition of a financial guarantee contract should fall within the scope of IAS 39. However neither the insurance contract definition within IFRS 4, nor the financial guarantee contract definition in the ED distinguishes between financial guarantee contracts issued and those held, including those ceded through reinsurance. As a consequence, they both appear to be within the scope of IAS 39 even though it indicates that only financial reporting for the issuer is addressed in the ED. If the reporting entity is a holder of the financial guarantee, e.g., as a result of ceded reinsurance, inconsistent measurement could result. The case of a guarantee held can introduce a similar problem – if it were held as an asset, it would have to be measured at fair value, rather than the more complex measurement approach proposed.

This mismatch between the treatment of guarantees held and issued introduces non-symmetrical measurement bases. For example, based on the ED, a credit insurer may hold reinsurance contracts to transfer losses arising from the financial guarantee contracts it has issued, or a bank may buy protection on a portfolio of financial guarantee contracts. The reinsurance contracts will be carried at fair value, whereas the financial guarantee contracts will be measured at the higher of the amortized premium or the amount determined in accordance with IAS 37.

There can be a significant difference between guarantees offered by insurers and guarantees offered by other financial institutions such as banks. In many cases, banks provide guarantees to creditors of their clients based on their individual experience with the debtor from an extensive business connection. The guarantee is only one part of that relationship, either since the bank is itself affected by the credit risk of the debtor by providing loans or other investment services. In contrast, insurers normally provide guarantees to creditors without having any relationship with or individual knowledge about the debtor. The insurer includes the guarantee to a large portfolio or pool of similar guarantees, while the bank adds the guarantee to its other business with the individual debtor.

In some cases, both insurers and banks hold guarantees in large portfolios and apply the principle of risk equalization or pooling, equivalent to the insurance business approach. It would be premature to now decide that this portfolio approach is irrelevant from an accounting view before the

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insurance contract and financial instrument projects clarify this issue overall.

In summary, we do not believe that requiring two different measurement bases is appropriate in these circumstances and recommend further study of this issue before being adopted.

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 (i.e. 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?

IAA Response: The Exposure Draft does not adequately deal with several important measurement issues associated with financial guarantee contracts issued by insurance entities, including renewal premiums, appropriate provisions for risk, surety contracts and ceded reinsurance. We believe that the current treatment given in IFRS 4, i.e., that these contracts should be subject to an acceptable liability adequacy test should suffice until the results of the current IASB insurance contract and financial instrument projects are completed.

Regarding renewal premiums, the ED states that the premium received is likely to equal the fair value at inception unless there is evidence of the contrary. Although this might be the case for single premium contracts, it may not be the case for many periodic payment contracts. This does not address those financial guarantee contracts for which the premium is paid in instalments, e.g., many mortgage guaranty and property insurance contracts. For example, for a monthly payment (level premium) mortgage guarantee contract, the first month premium does not necessarily correspond to the risk associated with the insurance risk for that period.

If this ED would be adopted in some form, it should also address the measurement of a financial guarantee contract purchased as protection against credit related losses arising from specified unsecured trade receivables/loans. This would require a financial guarantee contract held as collateral to be included in the assessment of the cash flows in

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determining the amount of impairment loss on an impaired asset, rather than as a separate financial asset in its own right.

Further, the proposed ED may well result in misleading financial statements. Currently, credit insurers often allocate premiums received proportional to periods of coverage, releasing them pro rata as revenue or for the periods of payment if paid on installments. Whenever a claim is reported (or is expected to be incurred) a claim (including IBNR) liability is established and released when the claim is settled by payment or rejection. The proposed treatment would first allocate the premium to periods (probably including the settlement period after the end of the coverage period) proportionally, but is replaced whenever the discounted present value of future payments becomes larger. The resulting change in measurement might be quite difficult-to-explain. During the coverage period, a significant part of earnings is released, even though the associated uncertainty has hardly changed. The earnings in this case would not reflect economic reality.

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?

IAA Response: *Given the issues raised above, we believe that the effective date should be coordinated with the completion of the current IASB insurance contract and financial instrument projects.*

We believe the principle of the proposed transition is appropriate.

Question 5– Other comments

Do you have any other comments on the proposals?

IAA Response: *We do not believe that the individual transaction focus of IAS 39 works (i.e., does not produce relevant measures) for products for whom a major purpose is risk diversification. This is true both for insurance contracts and for bank loan portfolios. Stand-alone contracts should be valued differently than portfolios because of these risk diversification benefits.*

As a result, a major problem with the proposal is not which IASB standard should cover financial guarantees, but how portfolios of products should

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be valued where a major feature of the product is the risk diversification benefit of the portfolio. The unit of account should not be individual contracts for such a situation – rather, it should be the portfolio.

While the Basis for Conclusions (BC 18(a)) states that IAS 37 does not have to be applied on a contract by contract basis, such a statement seems to be in conflict with paragraph 47(c), which talks about the measurement of “a” financial guarantee contract, and says to measure “it” based on IAS 37. Hence, the wording in paragraph 47 seems to require the application of IAS 37 on a contract by contract basis, even if IAS 37 itself does not preclude application to a portfolio of contracts (where a standard provides that option for the application of IAS 37).

Members of the IAA's Insurance Accounting Committee

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W. Paul McCrossan	(Vice-chair)
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Clive Aaron	Institute of Actuaries of Australia
William Abbott	Institute of Actuaries
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Full Member Associations of the IAA

Consejo Profesional de Ciencias Económicas de la Ciudad Autónoma de Buenos Aires
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Institute of Actuaries of Australia (Australia)

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