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7 October 2004

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Andrea Pryde
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To: CommentLetters@iasb.org.uk

Dear Ms Pryde,

Exposure Draft of Proposed Amendments to IAS 39 and IFRS 4
Financial Guarantee Contracts and Credit Insurance

I am writing on behalf of the London Investment Banking Association (LIBA) to comment on the IASB Exposure Draft of proposed amendments to IAS 39 and IFRS 4 – Financial Guarantee Contracts and Credit Insurance, which was published on 8 July. LIBA is, as you know, the principal UK trade association for investment banks and securities houses; a full list of our members is attached.

Financial instruments form a key component of the European business activities of the majority of LIBA members. We have therefore closely followed, and have in large measure supported, the IASB work on accounting for financial instruments, and we are very pleased to have the opportunity to comment on this further Exposure Draft.

Overall, we do not find the proposals in the Exposure Draft to be clear or consistent, and we believe the proposals should in certain respects go further. Our detailed responses to the questions in the Invitation to Comment section of the ED are set out below.

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 agree that it should be the substance of a contract, rather than its legal form, that determines the appropriate accounting treatment, but we have identified several instances in the ED where this approach is not applied. More specifically, we believe that this is highlighted in the different accounting treatment prescribed by the ED for a financial guarantee issued on a transferred asset that has been derecognised in accordance with IAS 39 and a financial guarantee issued as a stand-alone arm's length transaction to an unrelated party.

To illustrate this difference, a financial guarantee contract issued in a stand-alone arm's length transaction with an unrelated party is initially recorded at fair value. The proposed guidance in the ED precludes the use of the fair value option (paragraph 47(a)) and will require subsequent measurement of the financial guarantee at "the higher of:

i) the amount determined in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets; and

ii) the amount initially recognised … less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 Revenue."

In contrast, AG.4A (a)(ii) of the ED proposes that a financial guarantee contract that "was entered into or retained on transferring to another party financial assets" should, when derecognition of the asset is achieved, be accounted for as derivative with changes in fair value recorded through profit or loss.

Although the substance of the two transactions is the same, the subsequent measurement of the financial guarantees is different. That is, the first transaction requires accrual accounting, whilst the second transaction is recorded at fair value with changes recorded in profit and loss. We believe this demonstrates inconsistent application of the principle of substance over form.

This inconsistent application is also demonstrated by related inherent contradictions within the Exposure Draft. For example, there are conflicting references as to whether or not financial guarantees should be accounted for as a derivative and recorded at fair value through the profit and loss. Paragraph 9(iii) states that financial guarantees that meet the definition of a derivative may not be classified as held for trading (i.e. carried at fair value through profit and loss). Paragraph AG4A(a)(ii), however, states that a financial guarantee contract that is entered into or retained through the transfer of a derecognised asset, is accounted for as a derivative with changes in fair value recorded through the profit and loss.

We propose that the standard should be changed to allow election of the fair value option financial guarantee contracts and that, if the fair value option is not elected, then the subsequent measurement should be in accordance with IAS 37 and IAS 18 (i.e. paragraph 47(c)). This would at least allow entities to select subsequent fair value measurement where this better reflected the substance of the transaction.

We have, furthermore, never supported the continuing involvement accounting that can arise from a derecognition transaction – in particular the double counting that results. In our view, the proposals in this ED not only introduce a third method for accounting for financial guarantees, but also go further to highlight the fact that the continuing involvement accounting already in the standard is inconsistent with the principle that transactions should be accounted for according to their substance. We find it confusing and unnecessary to have three different forms of accounting for what is in substance a single form of contract.

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?

We agree that all financial guarantees should be included in the scope of IAS 39, as this should provide the most flexibility to enable transactions to be accounted for following their substance, rather than their legal form. In particular, as noted above, including financial guarantees in IAS 39 provides the best framework through which to allow subsequent measurement at fair value, if considered appropriate. If an entity chooses not to measure a financial guarantee at fair value subsequent to initial recognition, it would then be appropriate for the subsequent measurement to fall under IAS 37 and IAS 18, pending the completion of Phase II of the insurance project.

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?

As noted above, we do not agree with the proposal in the ED. We believe entities should have the ability to carry a financial guarantee at fair value irrespective of whether the financial guarantee is part of a derecognition transaction or not. Consequently, we believe entities should be given the choice to measure financial guarantees subsequently at fair value. If an entity chooses not to recognise a financial guarantee at fair value subsequent to initial recognition, we believe it is currently appropriate for the measurement guidance in IAS 37 and IAS 18 to be used.

Question 4 – Effective Date

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?

We agree in principle that the proposals should be applied retrospectively and that earlier application should be allowed. However, given our comments above, we believe that further changes should be made before the proposals are issued in final form and we believe that these would benefit from re-exposure. Consequently, although we would like these proposals to be finalised as soon as possible, ideally allowing entities to apply them from 1 January 2005, we do not believe this will be practical. In addition, we believe the Board may have underestimated (in paragraphs BC27-28) the work that will be involved in obtaining the required information, so we ask that the Board considers this when finally determining the mandatory effective date.

Question 5 – Other Comments

Do you have any other comments on the proposals?

Fair Value Measurement Considerations

We are concerned that the ED, in IN3(a), attempts to define initial fair value. Our view is that IAS 39 already contains guidance on fair value measurement, including at initial recognition, and that this guidance should be used consistently for all applications of fair value. Summarising or paraphrasing this guidance could result in different approaches being taken to fair value measurement, which we do not support.

Updated References

If the Board elects to adopt the proposed amendment in its current form, then we recommend that the following amendments should be made to IAS 18 and IAS 37 to incorporate the newly amended IAS 39:

1. amend paragraph 6(c) of IAS 18 so as not to exclude financial guarantee contracts within the scope of IAS 39; and

2. amend paragraph 2 of IAS 37 so as not to scope out financial guarantee contracts within the scope of IAS 39.

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I hope that the comments in this letter are helpful. We would of course be very pleased to expand on any particular points which you may find unclear, or where you would like further details of our views.

Yours sincerely

Ian Harrison
Director

LONDON INVESTMENT BANKING ASSOCIATION

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Arbuthnot Securities Limited
BNP Paribas
Banc of America Securities Limited
Barclays Capital
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