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Andrea Pryde
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International Accounting Standards Board
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24 September 2004

Dear Andrea

Proposed amendments to IAS 39 on Financial Guarantee Contracts

The Accounting Standards Board is grateful for the opportunity to comment on the proposed amendments referred to above.

We support the proposals in the Exposure Draft. As we understand that some commentators are likely to argue that financial guarantee contracts that are insurance contracts should not fall within the scope of IAS 39, we thought it might be helpful to enclose a copy of the letter we sent to EFRAG on that subject.

The ASB is currently consulting on the proposals contained in the IASB exposure draft. We will pass on to you any views expressed to us that are relevant to your consultation.

Yours sincerely

I. Mackintosh

Ian Mackintosh
Chairman

Attachment: Copy letter

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Stig Enevoldsen
Chairman
European Financial Reporting Advisory Group
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Belgium

24 September 2004

Dear Stig

EFRAG's Preliminary Views on the IASB's Exposure Draft of Proposed Amendments to IAS 39 and IFRS 4 concerning Financial Guarantee Contracts and Credit Insurance

The Accounting Standards Board is grateful for the opportunity to comment on the preliminary views referred to above.

(In your letter, you use the following terminology: 'credit insurance' is a financial guarantee contract that meets the definition of an insurance contract; and a 'financial guarantee contract' is a financial guarantee contract that is *not* also an insurance contract. For simplicity we have adopted the same terminology in this letter.)

We understand that the rationale underlying the IASB's proposals is that the difference between credit insurance and financial guarantee contracts is a difference of form only, and should therefore not be allowed to affect the accounting; contracts that are in substance the same should be accounted for in the same way. EFRAG, on the other hand, is arguing that the difference is (a) one of substance and (b) a difference that could justify different accounting.

We recognise that credit insurance and financial guarantees are often used differently. That fact could be used to support the argument that the difference is one of substance. On the other hand, there are also many circumstances in which they are clearly interchangeable, and in those circumstances it seems reasonable to argue that the difference is one of form rather than substance. For that reason we think that, rather than try to argue one position or the other, it would be best if EFRAG's letter focused exclusively on what the differences in accounting would be and whether those differences are appropriate.

With that suggestion in mind, the remainder of this letter analyses the accounting implications of the proposals and considers whether the changes implied are appropriate.

IAS 39's measurement requirements, rather than those in IFRS 4, would apply

Under IFRS 4, any liability arising from a credit insurance contract is required to be measured at an amount that is at least sufficient to meet the liability adequacy tests set out in paragraphs 16 and 17 of the standard. However, although the standard suggests that the minimum amount should be determined by reference to current estimates of future cash flows, it does not require the minimum amount to be the IAS 37 amount. Under the proposals in the ED, this would change; as paragraph IN4 of the ED explains, the main practical effect for stand-alone credit insurance contracts is that they will be required to be measured at an amount that is at least equal to the IAS 37 amount. To be precise, on initial recognition they are measured at fair value and subsequently they are measured at the higher of the IAS 37 amount and the unamortised initial fair value. In our view EFRAG needs to address in its letter whether this new measurement basis is appropriate.

Our view is that practice in this area would be improved by requiring all credit insurance liabilities to be measured at an amount that is at least equal to the IAS 37 amount. That appears to be the IASB's view as well. If it is not EFRAG's view, its letter should explain exactly why that is so.

We note also that EFRAG argues that it is not appropriate to require entities to change the way they account for credit insurance contracts at this time in case that change is reversed during Phase 2 of the IASB's insurance project. We agree that changes that are likely to be reversed should not be made at this time, but see no reason to believe that this change will be reversed. In our view, this change is consistent with the direction in which we believe insurance liability accounting will evolve.

Another concern of EFRAG's appears to relate to the unit of measure: the suggestion seems to be that IFRS 4 permits a portfolio measure to be applied whilst IAS 39 does not. However, IAS 39 refers to the amount at which the liabilities are carried in the balance sheet to be determined in accordance with IAS 37, and IAS 37 requires expected value to be used where a portfolio of contracts is involved. As a result, it appears to us that EFRAG's concerns may be unfounded.

The recognition and derecognition requirements of IAS 39 would apply

Of course, IAS 39 does not deal only with measurement: it also deals with recognition and derecognition. Another implication of the proposals is therefore that credit insurance would fall within the scope of IAS 39's recognition and derecognition requirements. Under those requirements, if a credit insurance contract is entered into or retained on transferring financial assets or financial liabilities to another party and that contract:

(a) prevents derecognition or results in continuing involvement, the contract should be accounted for in accordance with IAS 39.29-37 and AG47-AG52

(b) does not fall within (a), it should be accounted for as a derivative.

We understand, however, that it is unlikely that a credit insurance contract would be entered into or retained on transferring financial assets or financial liabilities to another party. If that is indeed the case, the proposals would seem to have no recognition and derecognition implications that should concern EFRAG.

Credit insurance contract would come within IAS 39's embedded derivative requirements

EFRAG's main concern seems to be with traditional credit insurance contracts. It appears unlikely that such contracts would involve embedded derivatives, so the fact that credit insurance would in theory come within the scope of the embedded derivative requirements should not be of any concern to EFRAG.

Summary

In our view if the IASB's proposals are to be rejected, the reason has to be that they would result in credit insurance being accounted for in a way that is not appropriate. However, on the basis of the brief analysis above it seems to us that the only significant implication that the proposals have for the accounting treatment of credit insurance is a change for the better. We urge EFRAG to complete the analysis we have started, then frame its comments solely in terms of that analysis.

Some will argue that, if the proposals do not have many implications, there is no point in proceeding with them. We do not share that view; the objective of the proposals is to tidy up a scope issue that could be the subject of accounting arbitrage. That the proposals do not appear to change accounting much in practice is in this context to be commended not criticised.

I am sure you will understand that, as the ASB is currently consulting on the proposals contained in the IASB exposure draft, we will be reconsidering the issues we believe it raises in the light of the results of that consultation.

Yours sincerely

I. Mackintosh

Ian Mackintosh
Chairman