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Dear Andrea

Exposure draft of proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts

Financial Guarantee Contracts and Credit Insurance

We appreciate the opportunity to respond to the International Accounting Standards Board's Exposure Draft of its proposed amendments to IAS 39 and IFRS 4.

We welcome IASB's intention to provide more clarity and consistency in financial instruments accounting. We also think that more significant improvements are needed to be made to have a comprehensive guidance on financial guarantees accounting. Our views are expressed in the answers to the questions raised in the Exposure Draft.

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.

Answer 1

We support the Board's attempt to treat financial guarantee contracts in accordance to their economic substance rather than legal form.
We believe that the substance of a contract should be distinguished by its nature, which is embodied in certain risks and rewards inherent in the instrument.
Financial guarantees issued are part of the operational activities of banks and insurance companies. The benefit they expect to get from these instruments is the increase of operating income, thus they practically can not serve as an efficient hedging instrument. The major risk that the issuer of a financial guarantee is exposed to is credit risk. Therefore the proposal of the Board to include insurance contracts that meet the definition of financial guarantee, as defined in the BC2 Exposure Draft, is appropriate and consistent with the *substance over form* principle.

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?

Answer 2

We agree that all financial guarantee contracts should be within the scope of IAS 39. However the Exposure Draft limits the definition of financial guarantee contracts only to those *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.*
Some credit insurance contracts, like credit default swaps, that require payment to be made by the issuer if a change occurs in a specified credit rating or credit index, in substance are financial guaranty contracts and are used as such by many banks and insurers in their operating activities. Although both parties of these credit derivatives are exposed to some other risks related to the definition and construing of "credit events", however, if carefully structured the only risk of the issuer would be credit risk. It is apparent that such synthetic guarantees are very similar in substance to traditional financial guarantee contracts.
We think that these kind of credit derivatives should be included in the definition of financial guarantee contracts and have the same accounting treatment.
As an alternative to the definition of financial guarantee contracts (paragraph 9 of IAS 39) we propose the following wording:

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because
a) a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument, or
b) a specified credit event (eg credit downgrade, apprehended default) occurs.

Such an amendment would not only assist users of financial statements to better estimate the overall credit risk exposure inherent in the entity's liabilities, but also would be in tune to credit risk disclosure provisions in IAS 32 paragraph 66-76 and the Board's overall goal for a principle based accounting.

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 recognized in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and
(b) the amount initially recognized (ie fair value) less, when appropriate, cumulative amortization recognized 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?

Answer 3

We believe that the measurement basis described in IAS 37 is a good ground for financial guarantee contracts' subsequent measurement. In general this measurement approach is in compliance with the accounting treatment for such contracts in financial institutions.
At the same time we do not see any essential difference between the measurement approach proposed by the Exposure Draft and the fair value model.
Let's review both measurement bases proposed in the Exposure Draft:

a) Unamortized premium - Premium received by the issuer in an arm's length transaction with an unrelated party is the fair value of the instrument at the inception. The premium is amortized by applying the effective interest method in accordance with IAS 18. Thus, the amount of the unamortized premium at any moment equals its fair value unless a negative change has occurred to the reference entity's credit risk.

b) The amount recognized in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets – if a negative change occurs to the credit risk of the reference entity, a new liability (provision) should be recognized in accordance with IAS 37. The liability is measured at the best estimate of the expenditure required to settle the obligation. In estimating the current amount of the future cash payments associated with the liability time value of money, as well as risks and uncertainties related to that liability are taken into account.

   Whilst admitting that uncertainties around these liabilities are sometimes rather significant we believe that in most cases it is possible to reliably determine their fair value by applying various statistical and financial valuation models, including expected value method described in IAS 37. It is worth mentioning that for risk management purposes one of the most frequently employed valuation methods for financial guarantees are option pricing models, which are allowed to be applied for fair value measurement under IAS 32.

   It follows from the above that, this approach (as described in IAS 37) is not in conflict with fair value definition.

Upon reviewing the two measurement bases, we conclude that they both are not materially different from fair value accounting. Therefore we propose that fair value should be applied for financial guarantee contracts' subsequent measurement.
This will be consistent with financial institutions' risk management practices and will be another step forward towards a comprehensive fair value accounting model for financial instruments.

If you have any questions in relation to this letter please contact us by phone at
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Yours sincerely,

Armen Dallakyan,
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