Our ref RJ - comment letter on proposed amendments to IAS 39 Financial Instruments

International Accounting Standards Board
Attn. Sandra Thompson
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Amsterdam, 5 October 2004

Dear Ms Thompson:

Comments on 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 your invitation to comment on the IASB Exposure Draft of Proposed Amendments to IAS 39, *Financial Instruments: Recognition and Measurement* and IFRS 4 *Insurance Contracts:* Financial Guarantee Contracts and Credit Insurance *(*hereafter referred to as ED*)*.

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 the legal form of a contract should not affect the accounting treatment and that contracts that are, from an economical point of view, in substance identical should be treated similarly for accounting and reporting purposes.

This starting point raises, however, two further questions: (a) can financial guarantee contracts be sufficiently clearly distinguished from credit insurance contracts and (b) if such distinction can be clearly made, are there measurement differences between credit insurance contracts under IFRS 4 and financial guarantee contracts under IAS 39.

Can financial guarantee contracts be sufficiently clearly distinguished from credit insurance?

In the Basis for Conclusions, the IASB clarifies that it has struggled to make a distinction between insurance and a credit product. Features that are often mentioned as distinguishing are the following:

- Credit insurance is based on pooling of risks within a portfolio. However, although many financial guarantees are guarantees for a specific counterparty risk and a specifically identified debt instrument, there are also many financial guarantees for portfolios of identified debt instruments. For this reason, we are not convinced that this argument really creates a solid distinction between credit insurance contracts and financial guarantees;

- The parties to a contract differ between credit insurance and financial guarantees. In case of a financial guarantee the issuer of the guarantee and the holder of the guarantee as well as the party whose obligation is being guaranteed is aware of the existence of the guarantee. In case of credit insurance only the issuer and the policyholder are party to the contract. For this reason, we believe that the risks in the two types of contracts are different, which would be a difference in substance that could result in different accounting treatment.

Are there measurement differences between the measurement of credit insurance contracts under IFRS 4 and financial guarantee contracts?

In case of financial guarantees, current IAS 39 requires such contracts to be initially measured at fair value with subsequent measurement at the higher of (a) the amount determined in accordance with IAS 37, and (b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 (IAS 39, paragraph 47). In general, we expect IAS 37 to provide the higher amount.

In case of (credit) insurance contracts under the scope of IFRS 4, subsequent measurement is, in general, based on local accounting policies, unless these policies do not include a liability adequacy test meeting certain requirements: in such cases, IAS 37 is applicable. Therefore, if a proper liability adequacy test is performed under local accounting policies, measurement under

IFRS 4 could result in a different amount than under IAS 39 with subsequent measurement under IAS 37/IAS 18, as described above. However, if such test in local GAAP is not adequate, IAS 37 is applicable. The Basis for Conclusions argues that – as a result of the liability adequacy test included in IFRS 4, the measurement differences between IFRS 4 measurement of credit insurance and the measurement proposed in the ED, are minimal. However, one of the potential differences relates to the reflection of the time value of money (BC23(d) and (e)) that is required under IAS 37, but not by some existing models that are allowed under IFRS 4. This difference may cause insurance companies to have to incur substantial costs in the period until phase II determines the accounting for all insurance contracts under IFRS, if local GAAP includes an appropriate liability adequacy test as defined in IFRS 4.

From the above it can be concluded that there may be reporting environments where the measurement of financial guarantees and credit insurance contracts would be similar, i.e. IAS 37, if such environments do not include an appropriate liability adequacy test as defined in IFRS 4. In such cases, IAS 37 will apply to both financial guarantees and credit insurance contracts.

In the Dutch reporting environment, there is no proper liability adequacy test applicable to financial guarantees if such contracts would be accounted for under IFRS 4, so the result would be the same as measurement under current IAS 37. We expect this would also be the case in many other reporting environments, since – traditionally – financial guarantees are not part of insurance accounting in many jurisdictions.

From this perspective it would be irrelevant under which standard financial guarantees would be accounted for: IAS 39 or IFRS 4. Given the fact that: (a) credit insurance has always been part of insurance accounting; (b) financial guarantees are already subject to current IAS 39; (c) credit insurance companies would suffer substantial cost for system changes to amend their systems, if a proper liability adequacy test is available in local GAAP; and (d) the 2005 deadline is only months away, we recommend to withdraw the present proposal and, instead, to clarify that credit insurance contracts are covered by IFRS 4.

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 refer to our response to question 1 for our comments in respect of the scope as proposed in the ED.

We propose that the definition of a financial guarantee in paragraph 9 of IAS 39 is clarified by adding the word 'specified' before 'debt instrument' at the end of the definition.

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?

We agree with the measurement for 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.

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?

We agree the proposals are appropriate, but recommend adding that if not practicable, retrospective application should not be required.

Question 5 – Other comments

Do you have any other comments on the proposal?

We do not have further comments.

If you have any queries regarding our comments and responses, please do not hesitate to contact us.

Yours sincerely,

Prof. dr. Martin Hogendoorn
Chair Council for Annual Reporting