The South African Institute of Chartered Accountants

8 October 2004

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Dear Madam

EXPOSURE DRAFT 187– *FINANCIAL GUARANTEE CONTRACTS AND CREDIT INSURANCES*

In response to your request for comments on Exposure Draft 187 – *Financial Guarantee Contracts and Credit Insurances*, attached please find the comment letter prepared by the South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not just a professional body, but also secretariat for the Accounting Practices Board (APB), who is the official standard-setting body in South Africa.

In principle, we support the view that all financial guarantees should be accounted for on the same basis, irrespective of their legal form and we also support the proposal to bring financial guarantee contract within the scope of IAS 39 and remove them from the scope of IFRS 4.

However, we believe that any change to the accounting treatment of financial guarantees, should address their treatment in the accounts of holders of such guarantees as well as issuers. We disagree with paragraph AG4A(a) and BC4 which state that the holder of such a financial guarantee should be scoped out of the standard.

We would like to thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact me should you wish to discuss any of our comments.

Yours sincerely

Cynthia Mbili
Project Director – Financial Services Sector

cc: Doug Brooking (Chairman of the Accounting Practices Board)
Prof Geoff Everingham (Chairman of the Accounting Practices Committee)

SAICA COMMENT LETTER ON ED 187

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 support the objective to account for contracts with the same economic substance in the same manner and agree that the legal form of such contracts should not affect their accounting treatment.

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 believe that the scope is appropriate except as noted below:

- We disagree with the scope limitation contained in the Exposure Draft (AG 4A (a) and BC 4), where the holder of such financial guarantees is scoped out of the standard. The amendments to be incorporated into IAS39 should also address the accounting treatment by the holders of such contracts, in order to avoid inconsistent treatment and a measurement mismatch. In our view, it is necessary that offsetting financial guarantees and credit insurance contracts be accounted for in the same manner, as that is how they are managed.

- The mismatch between the treatment of guarantees held and issued introduces non-symmetrical measurement bases. For example, 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 would be held at fair value whereas the financial guarantee contracts would be measured at the higher of the amortised premium and the amount determined in accordance with IAS 37.

- We are concerned that the scope and definition of a *"financial guarantee contract"* does not fully address the issues as to which contracts should be included within the scope, and when these contracts would be regarded as derivatives.

We propose that the Board provides additional guidance on the following questions:

- If a credit default swap (CDS) is not referenced to a specific underlying debtor, but to a certain percentage of a reference portfolio, should it be classified as a financial guarantee, or a derivative instrument?

- Would first-loss protection referenced to a portfolio of underlying accounts also qualify as a financial guarantee in terms of proposed changes as there is no specified debtor?

- When shorting a financial guarantee contract, there is exposure to risks similar to that of the issuer of the financial guarantee contract. Guidance is required as to whether this position would need to be treated as a financial guarantee contract. This would have the implication of creating inconsistency between the treatment of long and short positions.

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 believe that the proposal outlined above is appropriate. However, we would appreciate clarity and guidance on the following issues:

- The exposure draft states that the premium received by the issuer is likely to represent the fair value of the guarantee at inception unless there is evidence to the contrary. This does not address those financial guarantee contracts where the premium is collected in instalments. The exposure draft should clarify whether such contracts should be treated as annual rolling contracts or whether the initial value should be calculated as a discounted value of all gross premiums receivable over the life of the contract. The latter seems to be consistent with IAS 18.

- We would like to point out that applying IAS 37 for subsequent measurement may result in different accounting treatment for financial guarantee contracts and credit insurance. IAS 37 permits the measurement of the obligation to be done on an individual valuation basis as well as on a portfolio valuation basis.
- The exposure draft should also clarify what discount rate should be used in subsequent measurement. IAS 37 requires the use of current market rate, whereas IAS 18 is unclear.
- The reference to IAS 18 in the exposure draft is unclear. We would therefore appreciate a more specific reference to a particular paragraph and, potentially, a comment on the respective impact in the AG section of IAS 39.
- If the scope of the exposure draft is expanded to include holders of financial guarantees, we would appreciate clarification on the impact of financial guarantees on the measurement and presentation of the underlying items (protected by the guarantees). For example, what would be the impact of a purchased credit protection on a portfolio of loans on the measurement of that portfolio? We believe that the guarantee should be considered (and presented) as a separate asset. However, we are aware that in practice the treatment varies. Would the guarantee have any impact on the impairment calculation of the respective loans?
- We believe that both issuers and holders of financial guarantees should have the option to elect such contracts as carried at fair valued through the income statement. The election is available for all other instruments within the scope of IAS 39 and we do not see a conceptual basis for exclusion of financial guarantees.

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 that the earliest possible effective date is for annual periods beginning on or after 1 January 2006.

Question 5 – Other comments

Do you have any other comments on the proposals?

We understand that, if a credit guarantee contract meets neither the definition of a financial guarantee contract under the proposed amendment to IAS 39 nor the definition of a an insurance contract under IFSR 4, the instrument is to be measured as a derivative in terms of IAS 39, both by the holder and the issuer. However, we are of the opinion that it would be useful to have clarity on the treatment by the holder of a contract that is not a derivative and meets the definition of a financial guarantee contract.

The proposed definition refers to *"a specified debtor"*. However, in practice, guarantees are commonly issued with respect to a portfolio of debtors, or a book of loans. We would appreciate guidance regarding the classification and treatment of such guarantees.

The measurement basis adopted for financial guarantee contracts is the same as that used for the subsequent measurement of contingent liabilities recognised in a business combination (IFRS 3 paragraph 48). The Board should consider the consequential amendments to IFRS 3 when finalising this exposure draft.

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