IASB/FASB Joint Meeting - week beginning 17 May

IASB agenda reference	**2G**
FASB memo reference	**45G**

Project	**Insurance Contracts**
Topic	**Scope: Financial guarantees**

Purpose of this paper

1. This memorandum discusses whether financial guarantee contracts should be included in the scope of a future standard on the insurance contracts or in the scope of the financial instruments project. This paper's principal focus is on (a) financial guarantee insurance contracts (for non-payment of interest and principal on debt instruments), (b) mortgage guarantee insurance contracts, and (c) credit insurance contracts (for trade receivables).

Summary of Staff recommendations

2. The staff recommends the financial guarantee contracts such as those described in paragraph 1 should be included in the scope of the insurance contracts exposure draft. This recommendation rests principally on the notion that financial guarantee contracts that meet the definition of an insurance contract should be accounted for as insurance contracts. However, the staff also wants to remind the boards that they have reached tentative decisions specifically excluding the contracts noted in paragraph 4 from the scope of the insurance contracts standard.

Structure of the Paper

3. The rest of this paper is divided into the following sections:

   (a) Background (paragraphs 4 and 5)

   (b) Definition of an insurance contract (paragraph 6 and 7)

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update.* Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

(c) Financial guarantee contracts (paragraphs 8 through 23)

Background

4. At the March 2010 joint Board meetings, the boards tentatively decided that the scope of a standard on insurance contracts will exclude:

   (a) Warranties issued directly by a manufacturer, dealer, or retailer;

   (b) Residual value guarantees embedded in a lease;

   (c) Residual value guarantees provided by a manufacturer, dealer, or retailer;

   (d) Employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans; and

   (e) Contingent consideration payable or receivable in a business combination.

5. The boards expressed an initial preference that the scope of the standard should exclude fixed-fee service contracts, but noted that it would be undesirable to exclude contracts merely because they pay benefits in kind rather than in cash. The boards agreed to consider this initial preference at a future meeting. Financial guarantee contracts were not discussed at the March 2010 meeting.

Definition of an insurance contract

6. The boards also tentatively decided (at the March 2010 joint board meetings) to use the current definition of an insurance contract in IFRS 4, *Insurance Contracts*, for defining an insurance contract. That definition states:

   > A contract under which one party (the **insurer**) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the policyholder if a specified uncertain future event (the **insured event**) adversely affects the policyholder.

7. IFRS 4 includes other definitions related to the definition of an insurance contract, including:

   (a) **Insured event:** An uncertain future event that is covered by an **insurance contract** and creates **insurance risk**.

(b) **Insurance risk:** Risk, other than **financial risk**, transferred from the holder of a contract to the issuer.

(c) **Financial risk:** The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Financial guarantee contracts

Background

8. Financial guarantee contracts generally have attributes of both an insurance contract and a financial instrument. They pay out only if the policyholder (defined as including other beneficiaries) actually suffers a loss (an insurance notion), but the underlying risk is credit risk (often thought of as a financial risk, though not within the definition of financial risk in IFRS 4). In addition, some of these contracts are issued by insurers and others are issued by banks, other financial institutions or other entities. Both boards have had significant discussions about financial guarantee contracts. However, those discussions were at different times and related to different projects (those projects were not joint projects).

9. Because IFRS 4 is a temporary standard, the IASB adopted a stop-gap solution intended to make sure that all issuers of such contracts recognise a stand-ready obligation on issuing such contracts whilst avoiding requiring disruptive temporary changes by entities that see themselves as part of the insurance sector. The IASB achieved this by scoping these contracts into IFRS 4 and allowed insurance contract accounting, if issued by entities that had previously asserted explicitly that they regarded such contracts as insurance contracts and had accounted for these contracts using accounting applicable to insurance contracts. All other issuers are required to apply IAS 39, *Financial Instruments: Recognition and Measurement*, to these contracts (initial measurement at fair value, subsequent measurement at the higher of (a) the amount required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (b) the amount initially recognised less cumulative amortisation in accordance with IAS 18 *Revenue*.

10. When developing IFRS 4 (and subsequently), the IASB noted that financial guarantee contracts could easily fit into either accounting model. Appendix A of this memorandum includes an excerpt from the Basis for Conclusions of IAS 39 related to financial guarantee contracts. This excerpt not only provides insight into the challenges the IASB faced when first deliberating this topic, but also provides a useful comparison of IFRS and US GAAP for financial guarantee contracts

11. The FASB also struggled during the deliberations of FASB Statement No. 163, *Financial Guarantee Insurance Contracts,* to differentiate financial guarantee insurance contracts from some financial guarantees written by noninsurance entities. Ultimately, the FASB decided to follow the existing scope for insurance guidance and differentiate contracts by the type of entity that issues the contract (but acknowledged that some other contracts are similar). The FASB also found it difficult to distinguish between the financial guarantors covered by Statement 163 and other financial guarantors such as mortgage guarantors and credit insurers.

What is a financial guarantee?

12. Financial guarantee contracts generally have the same function as some derivative instruments. That function is that the issuer agrees to protect the holder of the contract or instrument. Both IFRS and US GAAP include the notion that the holder of the financial guarantee contract must be directly exposed to the risk being guaranteed (that is, the holder must hold the guaranteed asset, liability, or equity and be subject to a loss). This is similar to an insurance contract (as noted in paragraph 6, the specified uncertain future event must adversely affect the policyholder [also known as having an insurable interest]). Derivative instruments generally do not have such restrictions and the holder of the instrument can benefit even if the holder does not incur a loss (for example, a basket credit default swap does not require that the holder of the swap actually own any of the referenced securities).

13. In the guidance on implementing IFRS 4, IG Example 1: Application of the definition of an insurance contract, the notion of having to be exposed to a loss and incur a loss is illustrated.

Contract type	***Treatment in phase I***

1.11 Contract that requires specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. The contract may have various legal forms (eg insurance contract, financial guarantee or letter of credit).	Insurance contract. *Within the scope of the IFRS*, unless the contract was entered into or retained on the transfer of financial assets or financial liabilities within the scope of IAS 39. If the issuer's accounting policies do not require it to recognise a liability at inception, the liability adequacy test in paragraphs 15-19 of the IFRS may be particularly relevant. The legal form of the contract does not affect its recognition and measurement.
1.12 A financial guarantee that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a contract is one that requires payments in response to changes in a specified credit rating or credit index.	Not an insurance contract. Within the scope of IAS 39.

Which insurance contracts may meet the definition of a financial guarantee contract?

14. The definition of financial guarantee contracts in IFRS is "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." This definition captures a wider range of contracts than those within the scope of Statement 163 but tends to focus on debt instruments only. The Codification does not include a definition of a financial guarantee contract (it does include a definition of a financial guarantee insurance contract but that definition is based on the nature of the entity issuing the contract).

15. Contracts that have historically been accounted for as insurance contracts but meet the definition of a financial guarantee are financial guarantee insurance, mortgage guaranty insurance, and trade credit insurance. Generally the issuers of these

16. A brief description of each type of insurance follows including the relevant current accounting:

    (a) **Financial guarantee insurance:** The issuer of the insurance policy guarantees the holder (creditor) of a financial obligation (debt) the full and timely payment of principal and interest when due. The payments of principal and interest are based upon the debt payment schedule of the financial obligation. This debt payment schedule is set at inception however it can be revised for material volatility in the form of pre-payment levels, actual default experience and realized excess spread amounts. The guarantee is viewed as an unconditional and irrevocable guarantee to make debt payments if the issuer fails to pay when payment is due. The guarantee is not separately tradable but attached to the insured security. The insured security is generally marketable and traded on an active market.

    (b) **Mortgage guaranty insurance**: For convenience we describe features of the contracts that exist in the US, though similar contracts exist in other countries. The issuer of the insurance policy provides protection to the mortgage lenders from all or a portion of default-related losses on residential first-lien mortgage loans made primarily to home buyers who make down payments of less than 20% of the home's purchase price. This coverage can be provided for prime or non-prime residential mortgages at a specified coverage percentage. Private mortgage insurance also facilitates the sale of these mortgage loans in the secondary market to, principally, Freddie Mac and Fannie Mae. It should be noted that outside of the U.S., the mortgage guaranty insurance generally covers 100% of the risk as opposed to 20%. The insurance policy is not separately tradable but attached to the insured security. The insured obligation is generally marketable and traded on an active market through securitizations by Fannie Mae and Freddie Mac. These two GSE's, are the main beneficiaries to the majority of mortgage guaranty insurance. The accounting is similar to the short-duration accounting approach in FASB Statement No. 60 *Accounting and Reporting by Insurance Enterprises*. Under the Statement 60 short duration model, the premium is deferred (like a stand-ready obligation) and amortized over the

(c) **Trade credit insurance**: The insurance product provides coverage for an entity against non-payment for merchandise shipped or services rendered to a customer. Certain specified exclusions apply (such as losses due to trade disputes). Credit insurance products can be tailored to a wide range of covered losses. Credit insurance generally covers against the risk of not getting paid on trade accounts receivable following an insolvency. Some contracts will cover risk of protracted default (slow payment). Other contracts will include coverage for nonpayment due to political risks. The industry plays an essential role in enhancing and securing trade for small and medium sized entities. In US GAAP, these contracts also are accounted for as Statement 60 short-duration contracts.

17. The key similarity among these products is that they provide insurance protection for credit risks (debt payment, mortgage payment, receivable payment). The staff believes that so long as the financial guarantee contracts indemnify the insured against a loss, they fall within the insurance contracts definition and should be accounted for as insurance contracts. The result will be that other financial guarantees issued by other entities (such as banks) also be accounted for under insurance contracts—so long as the guaranteed party must hold the underlying guaranteed instrument.

18. In the FASB project, Accounting for Financial Instruments, the scope includes financial guarantees except for the following financial guarantees:

(a) A guarantee that covers vendor rebates based on either sales revenue of or the number of units sold by the guaranteed party (a vendor rebate)

(b) A guarantee or an indemnification whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction

(c) A guarantee or an indemnification of an entity's own future performance

(d) A product warranty or other guarantee for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party

(e) A guarantee issued either between parents and their subsidiaries or between corporations under common control

(f) A parent's guarantee of its subsidiary's debt to a third party (whether the parent is a corporation or an individual)

(g) A subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent

19. The following paragraphs from IAS 39 describe the accounting for financial guarantees under IFRS4 and IAS 39.

Paragraph AG4 from IAS 39:

Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2(e)):

(a) Although a financial guarantee contract meets the definition of an insurance contract in IFRS 4 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or IFRS 4 to such financial guarantee contracts. If this Standard applies, paragraph 43 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 29–37 and AG47–AG52 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

   (i) the amount determined in accordance with IAS 37; and

   (ii) the amount initially recognized less, when appropriate, cumulative amortization recognized in accordance with IAS 18 (see paragraph 47(c)).

(b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in this Standard, and are not insurance contracts, as defined in IFRS 4. Such guarantees are derivatives and the issuer applies this Standard to them.

(c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies IAS 18 in determining when it recognises the revenue from the guarantee and from the sale of goods.

20. Paragraph AG4A from IAS 39:

> Assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation and financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements typically include a statement that the issuer has used those accounting requirements.

21. Because the boards rejected a measurement based on fair value, it will be difficult to reconcile accounting for insurance contracts with the accounting for the types of contracts for which fair value is used (eg many financial instruments). Further, the measurement in the insurance contracts project is being created specifically for insurance contracts and with insurance contracts in mind. In addition, the presentation and disclosures will be tailored to the insurance industry. For some of those contracts (financial guarantees) that have historically been provided by noninsurance entities, the staff believes that the transition to insurance accounting could be difficult.

22. But similarly including some insurance contracts in financial instruments accounting could be a difficult transition for insurers.

Staff recommendation

23. The staff recommends that contracts that meet the definition of insurance should be accounted for as insurance contracts. The staff believes the intent of the project (and the boards) has been to have like or similar transactions accounted for similarly which really leaves little alternative other than to account for the financial guarantees that indemnify the holder as insurance contracts.

Question for the boards
Do the boards agree with the staff recommendation in paragraph 23?

A1. An excerpt from the Basis for Conclusions of IAS 39 related to financial guarantee contracts follows. The staff believes that the discussion is instructive in understanding the decisions surrounding the scope for IFRS 4:

BC21 In finalising IFRS 4 *Insurance Contracts* in early 2004, the Board reached the following conclusions:

(a) Financial guarantee contracts can have various legal forms, such as that of a guarantee, some types of letter of credit, a credit default contract or an insurance contract. However, although this difference in legal form may in some cases reflect differences in substance, the accounting for these instruments should not depend on their legal form.

(b) If a financial guarantee contract is not an insurance contract, as defined in IFRS 4, it should be within the scope of IAS 39. This was the case before the Board finalised IFRS 4.

(c) As required before the Board finalised IFRS 4, if a financial guarantee contract was entered into or retained on transferring to another party financial assets or financial liabilities within the scope of IAS 39, the issuer should apply IAS 39 to that contract even if it is an insurance contract, as defined in IFRS 4.

(d) Unless (c) applies, the following treatment is appropriate for a financial guarantee contract that meets the definition of an insurance contract:

(i) At inception, the issuer of a financial guarantee contract has a recognisable liability and should measure it at fair value. If a financial guarantee contract was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.

(ii) Subsequently, the issuer should measure the contract at the higher of the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

BC22 Mindful of the need to develop a 'stable platform' of Standards for 2005, the Board finalised IFRS 4 in early 2004 without specifying the accounting for these contracts and then published an Exposure Draft *Financial Guarantee Contracts and Credit Insurance* in July 2004 to expose for public comment the conclusion set out in paragraph BC21(d). The Board set a comment deadline of 8 October 2004 and received more than 60 comment letters. Before reviewing the comment letters, the Board held a public education session at which it received briefings from representatives of the International Credit Insurance & Surety Association and of the Association of Financial

Guaranty Insurers.

BC23 Some respondents to the Exposure Draft of July 2004 argued that there were important economic differences between credit insurance contracts and other forms of contract that met the proposed definition of a financial guarantee contract. However, both in developing the Exposure Draft and in subsequently discussing the comments received, the Board was unable to identify differences that would justify differences in accounting treatment.

BC23A Some respondents to the Exposure Draft of July 2004 noted that some credit insurance contracts contain features, such as cancellation and renewal rights and profit-sharing features, that the Board will not address until phase II of its project on insurance contracts. They argued that the Exposure Draft did not give enough guidance to enable them to account for these features. The Board concluded it could not address such features in the short term. The Board noted that when credit insurers issue credit insurance contracts, they typically recognise a liability measured as either the premium received or an estimate of the expected losses. However, the Board was concerned that some other issuers of financial guarantee contracts might argue that no recognisable liability existed at inception. To provide a temporary solution that balances these competing concerns, the Board decided the following:

(a) If the issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 to such financial guarantee contracts.

(b) In all other cases, the issuer of a financial guarantee contract should apply IAS 39.

BC23B The Board does not regard criteria such as those described in paragraph BC23A(a) as suitable for the long term, because they can lead to different accounting for contracts that have similar economic effects. However, the Board could not find a more compelling approach to resolve its concerns for the short term. Moreover, although the criteria described in paragraph BC23A(a) may appear imprecise, the Board believes that the criteria would provide a clear answer in the vast majority of cases. Paragraph AG4A gives guidance on the application of those criteria.

BC23C The Board considered convergence with US GAAP. In US GAAP, the requirements for financial guarantee contracts (other than those covered by US standards specific to the insurance sector) are in FASB Interpretation 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). The recognition and measurement requirements of FIN 45 do not apply to

guarantees issued between parents and their subsidiaries, between entities under common control, or by a parent or subsidiary on behalf of a subsidiary or the parent. Some respondents to the Exposure Draft of July 2004 asked the Board to provide a similar exemption. They argued that the requirement to recognise these financial guarantee contracts in separate or individual financial statements would cause costs disproportionate to the likely benefits, given that intragroup transactions are eliminated on consolidation. However, to avoid the omission of material liabilities from separate or individual financial statements, the Board did not create such an exemption.

BC23D The Board issued the amendments for financial guarantee contracts in August 2005. After those amendments, the recognition and measurement requirements for financial guarantee contracts within the scope of IAS 39 are consistent with FIN 45 in some areas, but differ in others:

(a) Like FIN 45, IAS 39 requires initial recognition at fair value.

(b) IAS 39 requires systematic amortisation, in accordance with IAS 18, of the liability recognised initially. This is compatible with FIN 45, though FIN 45 contains less prescriptive requirements on subsequent measurement. Both IAS 39 and FIN 45 include a liability adequacy (or loss recognition) test, although the tests differ because of underlying differences in the Standards to which those tests refer (IAS 37 and SFAS 5).

(c) Like FIN 45, IAS 39 permits a different treatment for financial guarantee contracts issued by insurers.

(d) Unlike FIN 45, IAS 39 does not contain exemptions for parents, subsidiaries or other entities under common control. However, any differences are reflected only in the separate or individual financial statements of the parent, subsidiaries or common control entities.