



Staff Paper

Project	Insurance contracts
Topic	Scope: Financial guarantee contracts

7What is this paper about?

1. The purpose of this paper is to ask:
 - (a) the IASB to exclude from the scope of the IFRS on insurance contracts the accounting for financial guarantee contracts, as defined in IFRSs.
 - (b) to ask the FASB whether financial guarantees, as defined in US GAAP should be accounted for as insurance contracts.
2. This paper also discusses intragroup guarantees.

Staff recommendations

IASB recommendations

3. The staff recommend that the IASB:
 - (a) carries forward in the IFRS for insurance contracts the existing option in IFRS 4 that:
 - (i) permits an issuer of a financial guarantee contract (as defined in IFRSs) to account for the contract as an insurance contract if it had previously asserted that it regards the contract as an insurance contract; and

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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.

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- (ii) requires an issuer to account for a financial guarantee contract (as defined in IFRSs) in accordance with the financial instruments standards in all other cases. Such contracts would be measured initially at fair value (typically equal to the consideration received), with subsequent amortisation of that amount, coupled with a test for credit losses.
- (b) does not provide an exception for intragroup guarantees from the accounting for financial guarantees and financial guarantee contracts.

FASB recommendations

- 4. The staff recommends that the FASB should:
 - (a) exclude from the scope of the insurance contracts project the accounting for financial guarantees. This would mean that the insurance contracts standard would carry forward the existing guidance such that:
 - (i) Financial guarantees currently within the scope of Topic 944 (formerly FAS 60) should be within the scope of the insurance contracts guidance
 - (ii) Financial guarantees within the scope of Topic 815 (formerly FAS 133) and Topic 460 (formerly FIN 45) as well as financial guarantee insurance contracts within the scope of Topic 944 (formerly FAS 163) should not be within the scope of the insurance contracts guidance and should retain current accounting under those standards.
 - (b) continue current practice under existing U.S. GAAP that provides an exception from recognition requirements for intragroup guarantees.

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Background*Financial guarantees in IFRSs*

5. The term ‘financial guarantee’ is generally used to refer to contracts issued by a wide range of general business entities, insurance entities and other financial institutions. They may have various legal forms, such as guarantees, some types of letters of credit, credit default contracts or insurance contracts. Currently, IFRSs define a *financial guarantee contract* (‘FGC’) narrowly 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’. In this paper we will use the term ‘financial guarantee’ to indicate the range of contracts and ‘financial guarantee contract’ or ‘FGC’ as defined narrowly in IFRSs.
6. A FGC meets the definition of an *insurance contract* because the issuer of the contract agrees to compensate the policyholder in the event of an uncertain future event that would adversely affect the policyholder. The uncertain future event is the debtor defaulting on the payment.
7. FGCs are currently within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. However, if an issuer of FGCs 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 FGCs. (IAS 39 (paragraph AG4A) also states that assertions that an insurer explicitly regards contracts as insurance contracts are typically found throughout the insurer’s communications with customers and regulators, contracts, business documentation and financial statements.) The issuer may make that election contract by contract, but the election for each contract is irrevocable.
8. In addition, some contracts may be described as financial guarantees but do not meet the definition of a FGC in IFRSs because they do not require that the holder of the guarantee suffers a loss. In the staff’s view, such contracts are similar to

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loan commitments. Similarly, some credit-related guarantees require payments in response to changes in a specified credit rating or credit index. Such guarantees are not FGCs and would not meet the definition of an insurance contract. They are derivatives within the scope of the financial instruments standards.

Financial guarantees in US GAAP

9. Currently, financial guarantees are accounted for in US GAAP as follows:
 - (a) Financial guarantees (for example, credit default swaps) are within the scope of Topic 815, Derivatives and Hedging, if those guarantees meet the applicable criteria in Topic 815.
 - (b) *Financial guarantee insurance contracts*, which are defined as contracts issued by insurance enterprises that provide protection to the holder of a financial obligation from a financial loss in the event of a default, are within the scope of Topic 944, Financial Services—Insurance and follow an unearned premium model (formerly FAS 163).
 - (c) Insurance contracts that are similar to financial guarantee insurance contracts (for example, mortgage guarantee insurance) that are issued by insurance enterprises are within the scope of Topic 944 and follow insurance accounting (formerly FAS 60).
 - (d) Financial guarantees that are neither within the scope of Topic 944 nor within the scope of Topic 815 are within the scope of Topic 460, Guarantees (formerly FIN 45).

Proposals in the ED and the DP

10. The IASB's exposure draft *Insurance Contracts* (the ED) and the FASB's discussion paper *Preliminary Views on Insurance Contracts* (the DP) define an *insurance contract* as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to

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compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

11. In developing the ED, the IASB concluded that FGCs (as defined in IFRSs) are a subset of insurance contracts and that the proposed accounting model for insurance contracts is equally appropriate for this particular subset. Accordingly, the ED proposes that all FGCs would be within the scope of the insurance contracts standard.
12. The DP states that the definition of an insurance contract also would apply to some contracts that provide coverage against credit defaults (that is, contracts that require the issuer to reimburse the holder for a loss incurred when a debtor fails to make payments according to the original or modified terms of a debt instrument).

Relevant questions in the ED and the DP

13. Question 11(c) of the ED asked respondents the following:

Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

14. The DP did not ask specifically about financial guarantees, and any comments were made in the context of Question 3 of the DP, which asked respondents the following:

Do you agree with the proposed scope exclusions? Why or why not?

Summary of feedback on the ED and the DP

15. The IASB received 12 comment letters that addressed only the issue of whether FGCs that meet the definition of an insurance contract should be in the scope of the insurance contracts standard. The FASB also received comments specific to this issue through comment letters and other outreach. This issue was also

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addressed in other comment letters, particularly those of banks and bank assurers, but also regulators, standard-setters, accounting firms and others.

16. Generally there were four points of view expressed in the comment letters about how FGCs should be accounted for:
 - (a) Some, in particular credit insurers and some non-banking regulators, argue that FGCs should be included in the scope of the insurance contracts standard because they meet the definition of insurance contracts. They argue that the board should not create an exception to the principle that contracts that meet the definition of an insurance contract are within the scope of an insurance standard.
 - (b) Some, in particular the banks and bank regulators, think that FGCs should be accounted for in accordance with the financial instruments standards, rather than the insurance contracts standard (see paragraphs 19-21).
 - (c) Some note that consistency issues may arise and that permitting the application of different standards for the accounting for FGCs would make an arbitrary distinction between economically similar contracts. A few, eg regulators, standard setters and representative bodies welcome the proposal to account for FGCs consistently. (One bank regulator commented that it did not have a strong preference whether that should be in the insurance contracts standard as proposed or in the financial instruments standards). They think that consistent accounting will increase comparability, and improve current practice.
 - (d) Some suggest that the IASB retain the existing option that permits insurers to treat FGCs as insurance contracts and require other entities to treat them as financial instruments.
 - (e) Some responses to the FASB DP suggest that the option in US GAAP to elect fair value measurement should still apply for contracts that meet the definition of insurance contracts.

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17. In addition, some request that intra-group guarantees should be exempt from the proposed requirements. They observe that intra-group guarantees will often be given without any payments being made, and that these guarantees differ from transactions with arms-length third parties. Accordingly, they do not think that the costs of accounting for such contracts in accordance with the proposed standard would outweigh the benefit of the information obtained.

Account for FGCs as insurance contracts

18. Some, including those that agree that FGCs (as defined in IFRSs) should be included in the scope of the insurance standard because they meet the definition of insurance contracts, believe that it will be challenging for non-insurers to apply the insurance contracts standard. Some of those concerns are because making explicit current estimates will place more demands on systems and resources than the accounting for such contracts as financial instruments. Other concerns are related to the presentation for non-insurance entities. Some suggest that the boards provide further guidance on application for those entities.

Account for FGCs in accordance with IAS 32, IAS 39 and IFRS 9

19. FGCs insure against credit risk only. Some respondents to the IASB's ED argue that credit risk arising from a failure to pay is a type of financial risk, and that FGCs are no different from other instruments that financial institutions use to manage credit risk. Currently, most banks and financial institutions manage all credit default related products, including financial guarantees, in the same way, generally using expected loss techniques or fair value approaches.
20. Some argue that FGCs should be accounted for in accordance with IAS 32, IAS 39 and IFRS 9 for the following reasons:
- (a) it would be more appropriate to regard FGCs as financial instruments, rather than insurance contracts as, conceptually, they believe the credit

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risk arising from a failure to pay is a type of financial risk, rather than insurance risk.

- (b) accounting for FGCs in accordance with the insurance contracts standard is likely to be onerous for financial institutions that do not otherwise issue insurance contracts because it would require them to introduce insurance valuation expertise purely for external reporting purposes, without any incremental benefit to offset the cost.
 - (c) accounting for FGCs as insurance contracts would create an arbitrary line between credit-related derivatives (such as credit default swaps) and FGCs. The existing distinction in IFRSs depends on whether the holder must hold the underlying credit in order to make a valid claim under the contract and some believe that this distinction is not significant enough to warrant a difference in accounting treatment.
 - (d) banks and other financial institutions currently account for FGCs using the financial instruments standards and this works well in practice.
21. Furthermore some indicate that the recognition and measurement of FGCs should be consistent with the proposals in the IASB's project on amortised cost and impairment. They argue that at least some FGCs are similar to loan commitments that would be within the scope of that project because both instruments are subject to similar credit analysis and risk management. They therefore suggest that FGCs be addressed using the expected loss accounting model being developed in the project on amortised cost and impairment.
22. Some responses to the FASB's DP note the distinction made in US GAAP, which depends on whether the entity issuing the financial guarantee is an insurance enterprise.

Retain option in IFRS 4

23. Many respondents to the IASB's ED suggest that the IASB retain the current option in IFRS 4 that permits issuers to account for FGCs using either the

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insurance contracts standard or the financial instruments standards (a combination of IFRS 9/IAS 39 with IAS 37), if the issuer had previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, perhaps with some reference to how the issuer regards the contract. (Other issuers would continue to be required to apply IAS 37 and IAS 39/IFRS 9.)

Retain fair value option

24. Many respondents to the FASB's DP suggest that the FASB retain the current fair value option for financial instruments (including insurance contracts). Those constituents request that the boards clarify how measurement of financial guarantees using the building block approach will be superior to a fair value measurement.

Staff analysis and recommendation

Scope for IFRSs

25. In the staff's view, the difficulty in deciding whether FGCs should be in the scope of the insurance contracts standard or the financial instruments standards lies in two mutually incompatible propositions:
 - (a) FGCs meet the definition of an insurance contract because the issuer of the contract agrees to compensate the policyholder in the event of an uncertain future event that would adversely affect the policyholder. The uncertain future event is the debtor defaulting on the payment. Therefore FGCs should be accounted for in the same way as insurance contracts.
 - (b) FGCs are economically similar to other credit related contracts that are accounted for in accordance with IAS 32, IAS 39 and IFRS 9. Similar accounting should apply to similar contracts. Therefore FGCs should be accounted for in the same way as financial instruments.

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26. We do not regard the question of whether FGCs should be in the scope of the insurance contracts standard as a crucial question for this project. Furthermore, the IASB has historically had difficulty in distinguishing credit insurance contracts issued by credit insurers from FGCs issued by banks. In July 2004, the IASB published an exposure draft *Financial Guarantee Contracts and Credit Insurance* to determine the appropriate standard to apply to FGCs. The Basis for Conclusions to IAS 39 states:
- 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.
27. In the staff's view, the IASB is no more likely to identify differences between FGCs and credit insurance contracts now than in 2004.
28. The accounting treatment that would apply to FGCs within the scope of IAS 32, IAS 39 and IFRS 9 is currently under re-consideration as part of the IASB project on amortised cost and impairment. However, during December 2010, the IASB decided to postpone a decision on the accounting for FGCs in the amortised cost and impairment project in anticipation of redeliberations by the boards on the treatment of FGCs as part of the insurance contract project. This was to prevent preparers from having to change their accounting for FGCs twice – first as a result of the amortised cost and impairment project and again as a result of the insurance project.
29. In the staff's view, there might be benefit in waiting to see the outcome of the amortised cost and impairment project before concluding on whether the FGCs would be more appropriately accounted for as financial instruments or as insurance contracts. Therefore, the staff recommend that the existing option for FGCs in IFRS 4 be carried forward.

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30. Finally, although the current exception in IAS 39 was intended as a short-term solution, the IASB stated in paragraph 23B of the Basis for Conclusions to IAS 39:

“although the criteria described ... may appear imprecise, the Board believes that the criteria would provide a clear answer in the vast majority of cases.”

31. This belief appears to have been justified in practice as there seem to be no implementation problems that have been identified.

32. Accordingly, given the IASB’s proposed timetable and because the accounting for FGCs is still the subject of one of the IASB’s ongoing projects, we believe that concluding on the treatment of FGCs in this project is premature.

Question for IASB: Financial guarantee contracts

Do you agree that the Board should exclude from the scope of the insurance contracts project the accounting for financial guarantee contracts as defined in IFRSs? This would mean that the IFRS on insurance contracts would carry forward the existing option in IFRS 4 that:

(a) permits an issuer of a financial guarantee contract to account for the contract as an insurance contract if it had previously asserted that it regards the contract as an insurance contract; and

(b) requires an issuer to account for a financial guarantee contract in accordance with the financial instruments standards in all other cases. Such contracts would be measured initially at fair value (typically equal to the consideration received), with subsequent amortisation of that amount, coupled with a test for credit losses.

Scope for US GAAP

33. While some stakeholders believe financial guarantees should be included in the scope of the guidance on insurance contracts, others do not believe financial guarantees should be accounted for as insurance contracts. The staff believes that economically similar contracts should be accounted for in a similar manner, however there is a wide spectrum of financial guarantees offered in the market and understanding the characteristics of each type to identify the features that

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would determine whether or not the financial guarantee would be considered insurance would involve extensive further research and consideration. The staff has included a summary of various types of financial guarantees in Appendix A.

34. Given the proposed timetable and that guidance already exists under U.S. GAAP, the staff recommend that financial guarantees accounted for in accordance with Topic 815 and Topic 460 not be included in the scope of the guidance on insurance contracts. Additionally, the staff recommend that financial guarantee insurance contracts accounted for in accordance with Topic 944 (formerly FAS 163) should not be included in the scope of the insurance contracts guidance while all other financial guarantees accounted for in accordance with Topic 944 should be within the scope of the insurance contracts guidance.

Question for FASB: Scope
<p>Do you agree that the FASB should exclude from the scope of the insurance contracts project the accounting for financial guarantees?</p> <p>This would mean that the insurance contracts standard would carry forward the existing guidance such that:</p> <p>(a) Financial guarantees currently within the scope of Topic 944 (formerly FAS 60) should be within the scope of the insurance contracts guidance?</p> <p>(b) Financial guarantees within the scope of Topic 815 (formerly FAS 133) and Topic 460 (formerly FIN 45) as well as financial guarantee insurance contracts within the scope of Topic 944 (formerly FAS 163) should not be within the scope of the insurance contracts guidance and should retain current accounting under those standards?</p>

Intragroup guarantees

35. Intragroup guarantees eliminate on consolidation. However, some requested that entities should be exempt from accounting for such intra-group guarantees in separate or individual financial statements because they believe that the costs of accounting for such contracts in accordance with the proposed standard would outweigh the benefit of the information obtained (see paragraph 17).

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36. For the IASB, the issue of whether the benefits of accounting for intragroup guarantees in accordance with the draft IFRS would exceed the costs was previously considered by the Board. In paragraph BC23C of the Basis for Conclusions to IAS 39, the Board explained that it did not create an exception for intragroup transactions because failing to account for liabilities under such guarantees in an insurer's individual or separate financial statements might result in the omission of material liabilities. There were no arguments in the comment letters that would cause the Boards to revise that conclusion.

Question for IASB: Intragroup guarantees

Do you agree that the IASB should not provide an exception for intragroup guarantees from the accounting for financial guarantee contracts?

37. For the FASB, Topic 460 (formerly FIN 45) provides an exception to the recognition criteria for the standard. Paragraph 460-10-25-1 of Topic 460 states that the following types of guarantees are not subject to the recognition provisions of this Subsection:
- (f) A guarantee issued either between parents and their subsidiaries or between corporations under common control.
 - (g) A parent's guarantee of its subsidiary's debt to a third party (whether the parent is a corporation or an individual).
 - (h) A subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.
38. The staff do not recommend amending existing U.S. GAAP for guarantees at this time.

Question for FASB: Intragroup guarantees

Do you agree that the FASB should not amend guidance for intragroup guarantees accounted for under U.S. GAAP at this time?

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Appendix A: Summary of financial guarantees in US GAAP

The following table is a high level summary of common types of financial guarantees. The table is not all-inclusive as to the types of financial guarantees issued by various entities.

Type of guarantee	Description
Letters of credit and other financial guarantees	The entity issuing the guarantee is contingently liable for these letters of credit and other guarantees, which are primarily used to provide collateral for securities and commodities borrowed and to satisfy various margin requirements.
Derivative contracts	Some derivative contracts meet the accounting definition of a guarantee, including certain written options, contingent forward contracts, and credit default swaps.
Standby letters of credit	Such arrangements represent obligations to make payments to third parties if the counterparty fails to fulfill its obligation under a borrowing arrangement or other contractual obligation.
Market value guarantee	Such arrangements are issued to guarantee timely payment of a specified return to investors in certain affordable housing tax credit funds. These guarantees are designed to return an investor's contribution to a fund and the investor's share of tax losses and tax credits expected to be generated by a fund. The issuer of the guarantee may also guarantee the return of principal, including a specified rate of return.
Liquidity facilities	Investment banks often enter into liquidity facilities with SPEs and other counterparties, whereby the entity is required to make certain payments if losses or defaults occur. The entity acts as a liquidity provider to municipal bond securitization SPEs and for standalone municipal bonds in which the holders of beneficial interests issued by these SPEs or the holders of the individual bonds, respectively, have the right to tender their interests for purchase by the entity on specified dates at a specified price. The entity may have recourse to the underlying assets held by the SPEs in the event payments are required under such liquidity facilities as well as make-whole or recourse provision with the trust sponsors.
Whole loan sale guarantees	Investment banks sometimes provide representations and warranties that certain assets sold as whole loans conform to specified guidelines. The entity may be required to repurchase such assets or indemnify the purchaser against losses if the

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assets do not meet certain conforming guidelines.

General partner guarantees	If an entity is a general partner in certain private equity and/or real estate partnerships, the entity may receive distributions from the partnerships according to the provisions of the partnership agreements. The entity may be required to return all or a portion of such distributions to the limited partners in the event the limited partners do not achieve a certain return as specified in the partnership agreements.
ARS guarantees	Some investment banks enter into agreements with government agencies, which may require the entity to repurchase at par certain ARS held by retail clients that were purchased through the entity. Additionally, some entities agree to reimburse retail clients who have sold certain ARS purchased through the entity at a loss.
Trust preferred securities	Some investment banks establish trusts for the limited purpose of issuing trust preferred securities to third parties and lending the proceeds to the entity in exchange for junior subordinated debentures. The entity may directly guarantee the repayment of the trust preferred securities to the holders thereof to the extent the entity has made payments to the trusts on the junior subordinated debentures.
Indemnities	Investment banks often provide standard indemnities to counterparties for certain contingent exposures and taxes, including U.S. and foreign withholding taxes, on interest and other payments made on derivatives, securities and stock lending transactions, certain annuity products, and other financial arrangements. Indemnity payments could be required based on a change in the tax laws or change in interpretation of applicable tax rulings or a change in factual circumstances.
Exchange/clearinghouse member guarantees	Some investment banks are members of various U.S. and non-U.S. exchanges and clearinghouses that trade and clear securities and/or derivative contracts. The entity may be required to pay a proportionate share of the financial obligations of another member who may default on its obligations to the exchange or the clearinghouse.
Guarantees on securitized assets	Some investment banks provide representations and warranties that certain assets transferred in securitization transactions conform to specified guidelines. The entity may be required to repurchase such assets or indemnify the purchaser against losses if the assets do not meet certain conforming guidelines.
Merger and acquisition guarantees	Some investment banks, as banking advisors, may be required to provide guarantees in connection with certain merger and acquisition transactions (usually only required by European

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regulating authorities). As such, the entity provides a guarantee that the acquirer in the merger and acquisition transaction has or will have sufficient funds to complete the transaction and would then be required to make the acquisition payments in the event the acquirer's funds are insufficient at the completion date of the transaction. These arrangements generally cover the time frame from the transaction offer date to its closing date.

Stable value guarantees

Some investment banks enter into agreements whereby the entity may have additional obligations for pensions and other benefits. An entity may contribute some money at the start of the agreement and may have a future obligation to contribute additional amounts to the fund, contingent upon the performance of the fund.

Life insurance related guarantees

Some investment banks issue life insurance contracts and currently account for those contracts under FIN 45 (usually elect fair value option).