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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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8 October 2004

Dear Sir David,

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 are responding to your invitation to comment on the above Exposure Draft on behalf of the worldwide organisation and Global IFRS Board of PricewaterhouseCoopers.

In principle, we support the view that all financial guarantees should be accounted for on the same basis, irrespective of their legal form. Any change to the accounting treatment of financial guarantees, however, should at the same time address their treatment in the accounts of holders as well as issuers.

We do not support the Exposure Draft in its present form until the full implications of the proposals have been addressed. We do not share the view expressed in the Basis of Conclusion where it is indicated that the Board does not anticipate significant changes in the accounting treatment of financial guarantees in the accounts of issuers.

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

Yes, we agree that the legal form of 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?

Answer

We believe that the proposal to bring the measurement of all financial guarantee contracts within the scope of IAS 39 is appropriate. The Exposure Draft recognises that the substance of financial guarantee contracts is an exposure to credit risk, which is properly addressed in the context of financial instruments. However, the Exposure Draft produces inconsistencies between the various standards in the operation of the scope paragraphs.

The Exposure Draft proposes that the measurement of all insurance contracts that meet the definition of a financial guarantee contract should fall within the scope of IAS 39. However neither the insurance contract definition within IFRS 4, nor the financial guarantee contract definition in the Exposure Draft, distinguishes between financial guarantee contracts issued and those held. As a consequence, they both appear to be within the scope of IAS 39.

Financial guarantee contracts are held as financial assets. However, as derivative contracts they cannot be classified as held to maturity financial assets, loans and receivables, or available for sale financial instruments. All these measurement categories are clearly defined in IAS 39 to comprise only non-derivative instruments. The Exposure Draft explicitly scopes out financial guarantee contracts from the held for trading category but paragraph 46 of IAS 39 apparently requires them to be carried at fair value.

The different treatment of guarantees held and issued caused by the proposed amendments of the scope of IAS 39 and IFRS 4 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. Reinsurance contracts that meet the definition of a financial guarantee contract will be carried at fair value whereas the financial guarantee contracts issued will be measured at the higher of the amortised premium or the amount determined in accordance with IAS 37.

We do not believe that requiring two different measurement bases is appropriate in these circumstances and, if the Board decide not to defer the implementation of the Exposure Draft, we recommend extending the fair value option to financial guarantee contracts to address this issue. This would be consistent with the treatment of loan commitments under IAS 39 where the fair value option is already available.

We note that the definition of a financial guarantee contract in the Exposure Draft is not consistent with the definition in FAS 149 which refers only to the default of a debtor under a non-derivative contract. We recommend that the definition be amended to be consistent with US GAAP in this respect.

The proposed changes will have a significant impact on the separate financial statements of parents and subsidiaries that issue or hold intra-group financial guarantee contracts. Many of these entities will face major practical problems in adopting the Exposure Draft. Intra-group financial guarantee contracts tend not to be based on terms that are available in public markets. For example they often do not restrict the business activities of the guaranteed party or require collateral. Further, often there is no consideration exchanged between them. Accordingly, we believe that it will be difficult and costly to obtain reliable fair value measures in these circumstances. In this respect the Exposure Draft will introduce a new difference from US GAAP where financial guarantee contracts between parents and subsidiaries are exempt from the application of FIN 45 and the requirement to fair value the financial guarantee contract on initial recognition. The Board should consider a similar approach.

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 (i.e. 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?

Answer

We have divided our answer to this question in two parts. The first part deals with the issues arising from the measurement basis introduced by the Exposure Draft for financial guarantee contracts issued, the second with the subsequent measurement issues associated with the amendments to the scope of IAS 39 and IFRS 4 noted in question 2 (measurement of financial guarantee contracts held).

Measurement of financial guarantee contracts issued

The Exposure Draft does not adequately deal with two important measurement issues associated with financial guarantee contracts issued by insurance entities:

1 **Subrogation rights.** Issuers of financial guarantee contracts often have the right to acquire the debt instrument covered by the guarantee on default of the specified debtor. However, it is not clear how these rights should be recognised under IAS 37. Paragraph 37 suggests that this value should be taken into account in determining the measurement of the provision, since it would influence the amount that an entity would rationally pay to settle or transfer the obligation. On the other hand, since the cash flows from the debt instrument arise from a third party, the rights could be regarded as a reimbursement under paragraph 53. In this case the receipt of cash is

not virtually certain and no asset can be recognised. We recommend that IAS 37 is amended to clarify that the value of subrogation rights should be recognised when measuring the provision.

2 **Premiums collected by instalments.** The Exposure Draft states that the premium received is likely to equal the fair value at inception unless there is evidence of the contrary. This does not address those financial guarantee contracts when the premium is collected by instalments. The Exposure Draft should clarify whether such contracts should be treated as periodic rolling contracts, as is the case under US GAAP, or whether the consideration should be deemed to be the discounted gross premiums receivable over the life of the contract. The latter seems to be consistent with IAS 18.

Measurement of financial guarantee contracts held

The Exposure Draft should also address the measurement of a financial guarantee contract purchased as protection against credit losses arising from specified unsecured loans and receivables. This should require financial guarantee contracts held as collateral to be included in the assessment of separate cash flows in determining the amount of impairment loss on an impaired asset rather than as a separate financial asset in its own right.

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?

Answer

We believe the proposed effective date is appropriate.

Question 5– Other comments

Do you have any other comments on the proposals?

Answer

Disclosure requirements

The Exposure Draft states that financial guarantee contracts are insurance contracts within the scope of IAS 39. However, it is not clear which standard deals with presentation and disclosure. We recommend the addition of an explicit statement to clarify whether financial guarantee contracts are within the scope of IFRS 4 as far as presentation and disclosure is concerned or whether they will have to follow the requirements of IAS 32 (or indeed IAS 37). We believe that preparers will be confused if they need to refer to three different standards to identify all the accounting and disclosure requirements relating to financial guarantee contracts.

Insurance contracts issued in connection with the origination of loans

Entities often issue insurance contracts that would pay to the policyholder the amount of the outstanding balance of a loan originated by the same entity (or an entity within the same Group or another non-related entity) if the policyholder is adversely affected by an event specified in the insurance contract (for example death or critical illness or unemployment). We believe that such payment is not dependent on the default of the policyholder/debtor and the insurance contract does not meet the definition of a financial guarantee contract. We would recommend adding an example to the implementation guidance of IFRS 4 to clarify this matter.

Contingent liability recognised in a business combination

The measurement basis adopted for financial guarantee contracts is also used in IFRS 3 paragraph 48 for the subsequent measurement of contingent liabilities recognised in a business combination. The Board should consider in that context the implications arising from the finalisation of this Exposure Draft and produce any necessary consequential amendments.

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If you have any questions in relation to this letter please do not hesitate to contact Jochen Pape, Chair of the PwC Global IFRS Board (+49 211 981 2905), or Ian D Wright (+44 207 804 3300).

Yours sincerely

PricewaterhouseCoopers LLP