CL 59

<u>COMMENTS ON ED 187</u>

Comments are only provided in respect of certain of the questions posed in the draft exposure document.

Question 1 – Form of contract

The Exposure Draft deals with contracts that require 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.

Yes, we believe this addresses the "substance over form" issue. However, where it is clear that the legal nature of a specific contract creates economic reality which is not similar to the generic form of these transactions, it is clear that the legal form will dictate different treatment.

We are also concerned with the examples used in the above definition. A "letter of credit" is mentioned as one of the possible instruments which will be regarded as a "financial guarantee" as defined.

*However, looking at the general reference to these instruments in the proposed changes to the statement as well as the basis for conclusions, it is apparent that what is envisaged are instruments that allow for payment to be made by the issuer to the holder where the holders incurs a loss due to non-performance of a specified debtor of the holder – this is clear in the wording "…*the issuer to make specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment…".

Within the banking environment, various types of performance or lending related letters of credit/guarantees are used or issued to or on behalf of clients – examples would include standby letters of credit such as performance guarantees on a contract, facility guarantees, shipping guarantees or, most common probably, vanilla LC that guarantee performance (payment)on a contract on behalf of a client to a seller or vendor.

We are of the opinion that the intention of the proposed changes envisaged in ED 187 does not cover these instruments as these instruments will be recognised in terms of IAS 137.

We would appreciate confirmation of the above, or alternatively, if these normal banking related guarantees do fall within the ambit of "financial guarantees" as contemplated in ED 187, clarification should be provided on the appropriate accounting treatment.

Furthermore, if these instruments do not fall within the scope or definition of "financial guarantee", we would request the Board to clarify the situations in which "letters of credit" should be included, or alternatively remove the reference to these instruments in the definition of "financial guarantees".

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?

We are concerned that the scope and definitions of "financial guarantee contract" does not fully address the issues as to what kinds of contracts should be included within the scope, and when these types of contracts will be regarded as derivatives.

Specifically, guidance should be provided in connection with, and questions 1-3-a and 1-3-b of the Implementation Guidance Questions should be revisited to expand on and provide additional guidance on the classification of Credit Default Instrument which will specifically not be included within the envisaged scope of Financial Guarantee contracts.

Specifically we would propose that the Board provides additional guidance on the following examples:

1. *Would a normal Credit Default Swap instrument or a performance guarantee be regarded as a financial guarantee contract, and if not, are these contracts treated as derivatives?*
2. *What should a CDS that provides for payment only in the event of bankruptcy be classified as?*
3. *If a 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 more appropriately as a derivative instrument?*
4. *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?*
5. *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.*

If not, what changes do you propose, and why?

Please refer above.

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?

FirstRand agrees with the proposed methodology concerning initial recognition at fair value. Subsequent measurement at fair value creates difficulty as credit ratings are not freely observable in the market.

The Board should provide additional guidance on how situations of subsequent measurement should be approached where credit ratings are not freely available.

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?

No comment.

Question 5 – Other comments

Do you have any other comments on the proposals?