CL 56

Ms A Pryde
Assistant Project Manager
International Accounting Standards Board
30 Cannon Street,
London EC4M 6XH,

25 October 2004

Dear Ms Pryde

Proposed Amendments to IAS 39 Recognition and Measurement and IFRS 4 Insurance Contracts - Financial Guarantee Contracts and Credit Insurance

I apologise for the delay in forwarding our response and for any inconvenience that this may cause and we welcome the opportunity to respond to the above exposure draft.

Our main issue with the proposals is that the IASB has previously established a principle that the accounting for insurance contracts should all be considered in a project dealing specifically with these types of financial instrument and it has established a project to conclude on the accounting for such transactions. The introduction of a specific form of accounting for insurance contracts meeting the definition of a credit insurance contract appears to us to prejudge the outcome of insurance contracts project.

We could understand the IASB's concern on the accounting for credit insurance contracts if the transitional arrangements under IFRS 4 did not provide adequate guidance on the recognition of the minimum liability to be established for such contracts. However we believe that the existence of the liability adequacy test in IFRS 4 would preclude the omission of the measurement of such liabilities.

This issue is considered in IN4 which states that "*without the requirements proposed in this exposure draft, if the issuer carries out a liability adequacy test meeting minimum requirements described in paragraph 16 of IFRS 4, the issuer need not use IAS 37 to determine whether an additional liability should be recognised*". However, if the issuer does not undertake a liability adequacy test as prescribed in paragraphs 15 to 19 of IFRS 4 then paragraph 17 requires a measurement of the net liability at least equal to that calculated in accordance with IAS 37, Therefore, the overall effect of the proposed change would be to continue to value the liability in accordance with FRS 17 (in the absence of a liability adequacy test) or else to either

i. increase the recorded liability if the liability adequacy test (calculated in accordance with IFRS 4) gives a lower answer than the liability under IAS 37, or
ii. decrease the recoded liability if the liability adequacy test (calculated in accordance with IFRS 4) gives a higher answer than the liability under IAS 37.

The above analysis presumes that the IAS 37 calculation gives a higher answer than the calculation in [draft] paragraph 47(c)(ii) of the amendment to IAS 39. As far as the calculation required by this paragraph is concerned, we could find no guidance in the [draft] amendment to the standard as to the circumstances under which a credit insurance contract should be accounted for a service contract under IAS 18 other than that contained in the [draft] paragraph AG4(b). However, there is an implication from BC 23 and BC 24 that IAS 18 should be applied to all credit insurance contracts. In view of the fact that these contracts meet the definition of an insurance contract, we believe it be premature to mandate that insurance contracts are service contracts and should be accounted for under this standard.

Additionally the use of the wording *"when appropriate"* in paragraph 47(c)(ii) implies that there would be times at which IAS 18 would not be used. It would be helpful for the IASB to identify the circumstances in which IAS 18 is to be used and those when IAS 18 is not appropriate. If one assumes that there are circumstances in which IAS 18 is not used, then the amount of "*the amount initially recognised"* will set a floor for the minimum liability until such time as the exposure is extinguished and the liability derecognised in accordance with IAS 39. The impact of this treatment could be to defer recognition of the income arising from such contracts in a manner that could be considered over prudent when compared with the results arising under IAS 37.

Another issue of concern is the absence of any scope exclusion for financial guarantees issued by a member of a group to another group company. Such guarantees may be granted under terms that would not be offered to or by an entity outside the group. It is not clear how the initial value of such guarantees could be estimated in the absence of a market for such guarantees.

Additionally there is a risk that in the individual financial statements of an entity granting such a guarantee, the impact of the debt instrument covered by the guarantee could be recognised more than once. By way of example, in the financial statements of a parent guaranteeing the debt of a subsidiary, the amortised initial value of the guarantee could be recognised under the draft amendments, together with the guaranteed debt instrument itself (within the valuation of the subsidiary).

We understand that under FASB interpretation number 45, intra group guarantees are not reflected in the individual financial statements of the guarantor and we would encourage the IASB to consider the avoidance of a new divergence from US GAAP.

We attach our responses to the specific questions that the IASB raised concerning the draft standard. If you have any queries about our response please do not hesitate to contact me.

Yours sincerely

Doug Logan
Director, Group Technical Accounting.

ROYAL & SUNALLIANCE

Proposed Amendments to IAS 39 Recognition and Measurement and IFRS 4 Insurance Contracts - Financial Guarantee Contracts and Credit Insurance

Responses to questions on which comments were invited

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 concur that the IASB should pursue the objective that these transactions should be accounted for consistently. We do however have concerns with the principle that a treatment is prescribed at this stage for a specific type of insurance contract. We believe that this conclusion prejudges the outcome of the insurance contract project and could result in multiple changes for entities writing contracts meeting the definition as an insurance contract.

We also believe that IFRS 4 has adequate safeguards within it in the form of the liability adequacy test to ensure that entities record a liability for such transactions. We acknowledge that IFRS 4 permits a number of different accounting treatments for insurance contracts but do not believe that there is a case for, potentially, further inconsistencies to be introduced in the accounting for insurance contracts within an individual entity.

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?

The IASB acknowledge that some forms of financial guarantee meet the definition of an insurance contract. As previously discussed we see no justification for forcing insurers to change their accounting policies for accounting for a subset of their insurance contracts until the deliberations on the accounting for all insurance contracts have been concluded.

The proposed changes make decisions on the accounting for a subset of the population of insurance contracts that have not been confirmed through exposure such as the assumption that insurance contracts are service contracts (accounted for under IAS 18) and the basis of setting risk margins (in accordance with IAS 37). We believe these issues should be fully considered using the due process under phase II of the insurance project.

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?

In view of our comments under the previous two questions, we do not support the proposal above. In our view, accounting for contracts falling under IFRS 4 should continue to be in accordance with IFRS 4.

If the IASB does make the proposed changes above, we are unclear as to which contracts would fall under IAS 18. The [draft] changes appear to imply that all contracts would be accounted for as service contracts. We believe this conclusion to be premature in respect of insurance contracts. If the use of the words " when appropriate" can be taken to mean that IAS 18 is not applied to come such contracts, then we believe that IASB should classify those circumstances when treatment under IAS 18 is appropriate and those when it is inappropriate.

Assuming that there are circumstances when IAS 18 is not appropriate, it would appear that the draft wording above would require a minimum liability to be recognised at a measurement based upon the amount initially recognised. We take this to mean that this minimum liability would continue to be recognised until such time as the liability meets the criteria for derecognition under IAS 39.

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?

In view of earlier comments we make no comment upon the effective date.

Question 5 – Other comments
Do you have any other comments on the proposals?

We have set out in our covering letter, our concerns regarding the non-exclusion of intra group transactions from the scope of the draft standard and would encourage the IASB to review this issue.