IFC

October 8, 2004

Ms Andrea Pryde
Assistant Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

RE: Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts – Financial Guarantee Contracts and Credit Insurance

Dear Ms. Pryde:

The International Finance Corporation (IFC), a member of the World Bank Group, is pleased to comment on the International Accounting Standards Board's (the Board's) Exposure Draft, *Financial Guarantee Contracts and Credit Insurance* (the ED). IFC presently complies with US GAAP but is in the process of converting to IFRS. In addition, many of IFC's clients comply with IFRS. As a result, we are keenly interested in the developments in IFRS.

In general, we support the proposed approach in the Exposure Draft. We agree that financial guarantee contracts should fall under the scope of IAS 39. We are also generally supportive of the accounting guidance in the ED, but we do have questions about the subsequent measurement provisions, and will confine our commentary to that point (i.e., Question 3).

We are supportive that the ED provides guidance for subsequent measurement of the financial guarantee contract. However, we do not believe the guidance is clear, especially in situations where the guarantee fee is paid over a period of time. For example, we believe the guidance could be interpreted to say that probable losses, estimated after inception of the financial guarantee need not be expensed as long as the balance in the liability account initially established for the guarantee is at least as large as the probable loss amount. Under the interpretation, income from the guarantee (fees) would also not be taken to income, even if the guarantee fee continues to be paid. On the other hand, we also believe the guidance in the ED could be interpreted to say that the subsequent probable loss should be expensed directly. Under this interpretation guarantee fees would continue to be recognized in income. Annex 1 to this letter provides a numerical example of the journal entries and the income statement and balance sheet impacts of both possible interpretations. As the example indicates, we believe the "answers" resulting from the two alternative interpretations are sufficiently different so as to cause confusion. Accordingly, we suggest that the Board may wish to clarify its guidance for subsequent measurement and reporting of financial guarantee contracts. It may be helpful to acknowledge in the Standard itself that a financial guarantee contract where the premium is different so as to cause confusion. Accordingly, we suggest that the Board may wish to clarify its guidance for subsequent measurement and reporting of financial guarantee contracts. It may be helpful to acknowledge in the Standard itself that a financial guarantee contract where the premium is receivable over time consists of two accounting events: (1) a service for the stand ready obligation and (2) a contingent loss under IAS 37.

We recognize that the ED does not converge with US GAAP, namely FIN 45, in that FIN 45 is silent as to subsequent measurement. However, our interpretation under FIN 45 is that subsequent probable losses related to financial guarantees would be accrued, resulting in both an increase in the overall liability related to the guarantee and an expense on the income statement. We are not offering an opinion as to whether we believe the treatment under US GAAP is preferable, but we would note that if convergence is a factor to consider, then, this alternative may be more attractive.

We do appreciate the opportunity to comment. If you have any questions concerning our comments, please contact Sara Kenny in Washington, D.C. at (202) 458-7647.

Sincerely,

Allen F. Shapiro
Controller

IFC COMMENT LETTER
FINANCIAL GUARANTEE CONTRACT ED
8 OCTOBER 2004
EXAMPLE RELATED TO QUESTION 3

1. This paper explores 2 approaches to implement the Exposure Draft on IAS 39.

2. Assume Guarantor issues a guarantee on a $50,000,000 loan, payable over 10 years with 20 interest payment periods. Assume further that a portion of the guarantee fee is paid at the inception of the guarantee, and the remaining fees are paid over the term of the guarantee. If the guarantee fee is 3.25%, and the borrower's equivalent risk-rated borrowing rate is 8.50%, the journal entry required to record the guarantee at inception, under both alternatives will be:

	Journal Entry	Approach 1		Approach 2	
DR	Cash	812,500		812,500	
DR	Receivable under Guarantee	15,437,500		15,437,500	
CR	Liability under Guarantee		11,125,510		11,125,510
CR	Discount on Receivable under Guarantee		5,124,490		5,124,490

   a) Where $812,500 is the upfront fee received by the Guarantor at signing of the guarantee; and $11,125,510 is the present value of 20 payments of $812,500 each, discounted at 8.5% per annum, and $15,437,500 is the nominal amount to be received (19 payments of $812,500 each).

   b) It is important to note that the receivable is discounted because the payments to be received extend beyond one year. The amount of the discount is the difference between the nominal cash flows to be received and the present value of those cash flows. The discount is amortized into income over time, as part of the cash application process related to the receivable.

   c) It is also important to note that the journal entry demonstrated in this paragraph results in a "gross up" of the Guarantor's balance sheet on both the asset and liability sides, and that the receivable and liability recorded are from/to the same party. We suggest that this consequence be disclosed in the guarantees footnote.

3. Under Approach 1, subsequent to initial measurement, if a probable loss is assessed and is less than the initial measurement of the guarantee, the Guarantor would not directly record that probable loss. Rather, the Guarantor would measure the guarantee liability at the higher of the probable loss and the initially measured amount less any amortization. If the probable loss exceeds the initially measured guarantee amount (less any amortization), the Guarantor would record an Allowance for Guarantee Risk, to the extent of that excess. Also, upon the assessment of probable loss, the Guarantor would stop the amortization of the Liability under Guarantee.

4. Under Approach 2, subsequent to initial measurement, if a probable loss is assessed and is less than the initial measurement of the guarantee, the Guarantor would record an Allowance on Receivable under Guarantee, to the extent of the of the probable loss. Also, upon

recording an Allowance on Receivable under Guarantee, the Guarantor would stop the amortization of the Discount on Receivable under Guarantee.

5. To carry the example further, assume the underlying loan is callable after some period of time.[1] In that case, it is likely that the Guarantor would adjust either the guarantee fee, the borrower's equivalent risk-rated borrowing rate or both to take into account the call feature. To determine the fair value of the guarantee at inception, the Guarantor would have to estimate the probability that the loan would be called, and then, factor that probability into the present value computations. The example in this paper has been simplified, however, to assume that both the fee and the borrowing rates remain constant. Adjustment of the present value (to take into account probability of call) would not alter the basic format of the journal entry, namely a debit to Cash, debit to Receivable, credit to Liability Under Guarantee, and credit to Discount on Receivable from Guarantee Fee.

Subsequent Accounting for the Guarantee & Revenue Recognition

6. The guarantee liability initially recognized will be reduced (by a credit to revenue) subsequent to the initial recording as the Guarantor is released from risk under the guarantee. We propose that the cumulative amortization take place by reducing the liability ratably over the life of the guarantee and releasing to income each payment period an amount equal to a straight-line amortization of the amount recorded at the inception of the guarantee.

7. Continuing the example, the journal entries each semi-annual period, under both approaches would be:

   a) to record the release of the liability and recognition of revenue[2]:

	Journal Entry	**Approach 1**		**Approach 2**	
DR	Liability under Guarantee	556,275		556,275	
CR	Guarantee Fee Revenue		556,275		556,275

Where $556,275 is 1/20 of the total Liability under Guarantee of $11,125,510. It is important to note that the $812,500 received at the signing of the guarantee is <u>not</u> taken to revenue at that time. Rather, revenue is recognized, ratably, over the life of the guarantee, as the liability is relieved.

   b) Cash receipts from the guaranteed party should be recorded as follows:

[1] Several factors could lead to an early retirement of the loan, including a call feature or a prepayment option.
[2] Amortization is computed semi-annually for purposes of this example. In practice, amortization will occur monthly or daily.

	Journal Entry	Approach 1		Approach 2	
DR	Cash	812,500		812,500	
CR	Guarantee Fee Revenue		812,500		812,500

Where $812,500 is the amount of cash received.

c) Amortization of the discount should be recorded as follows:

	Journal Entry	Approach 1		Approach 2	
DR	Discount on Receivable under Guarantee	269,710		269,710	
CR	Interest Revenue		269,710		269,710

Where $269,710 is 1/19 of the total Discount on Receivable from Guarantee of $5,124,490. The Discount is amortized over 19 periods (instead of 20) because the Receivable extends over 19 periods, due to the upfront cash payment.

8. The balances in the various accounts, at this stage are summarized below:

	Approach 1 Cumulative balance $		Approach 2 Cumulative balance $		Difference $
Assets					
Cash		**1,625,000**		**1,625,000**	
Receivable under Guarantee	14,625,000		14,625,000		
Discount on Receivable under Guarantee	(4,854,780)		(4,854,780)		
Net Receivable under Guarantee		**9,770,220**		**9,770,220**	
Liabilities					
Liability under Guarantee	(10,569,235)		(10,569,235)		
Net Liability under Guarantee		**(10,569,235)**		**(10,569,235)**	
Income/Expense					
Guarantee Fee Revenue		**(556,275)**		**(556,275)**	
Interest Revenue		**(269,710)**		**(269,710)**	

9. The proposed ED will also impact the Guarantor's loss provisioning policies and procedures for guarantees. When the underlying loan is disbursed, the guarantee is considered to be "outstanding," and the Guarantor records a specific allowance for risk based on the credit risk rating of the guaranteed loan's borrower. At inception, under the ED, the initial measurement of the liability is the fair value of the guarantee at its inception[3].

10. When an outstanding guarantee is assessed for loss provisioning, the amount of allowance for risk recognized is dependent upon the credit risk rating of the borrower. The riskier the borrower, the higher the allowance for risk, and the more likely the guarantee will be called. If the guarantee is called, the Receivable under Guarantee will not be collected because the guaranteed party does not continue to pay the guarantee fee on a called guarantee. Therefore, the collectibility of the Receivable under Guarantee is not so much dependent upon the

[3] IN5 of ED

creditworthiness of the guaranteed party as it is dependent upon the creditworthiness of the borrower to the guaranteed loan.[4]

11. Returning to the example introduced earlier, assume the underlying loan is disbursed in the first period of the guarantee term (before the second guarantee fee payment is made), and the Guarantor determines that a 10% specific reserve against the guarantee is needed, i.e., a probable loss of $5,000,000.

12. The Liability under Guarantee account already has a balance of $10,569,235, which represents the amount initially recognized, less the cumulative amortization recognized. This balance is greater than the assessed specific reserve and therefore, under the ED no further liability should be recognized. However, since a probable loss of $5,000,000 has been assessed, some could argue that this loss should be recognized.

13. Under Approach 1, which represents a possible interpretation under the ED, no loss will be recognized at this time. However, income will not be recognized from the guarantee fees under Approach 1.

14. Under Approach 2, which also represents a possible interpretation under the ED, the probable loss will be recognized, and the Receivable under the Guarantee will be reduced. The amortization of the Discount on the Receivable under the Guarantee should cease at this stage. The amortization of the Liability under the Guarantee will continue, since the guaranteed party is continuing to make the cash payments for the guarantee fees.

15. The difference between the 2 approaches impacts the balances in the Guarantor's balance sheet, with respect to the Liability under Guarantee and Receivable under the Guarantee. The Guarantor's income statement is also impacted, and under Approach 2, the current period earnings appear to be lower than they would otherwise be, as under Approach 1. The tables below show the impact of the difference.

	Journal Entry	**Approach 1**		**Approach 2**	
DR	Guarantee Risk Expense			5,000,000	
CR	Allowance on Receivable under Guarantee				5,000,000

[4] Should the guaranteed party fail to make the required guarantee fee payments, IFC will cancel the guarantee, which is a different type of economic event. In other words, there is no concept of "non performing" for guarantee fees; the guarantee is either in effect (ie, "performing") or cancelled/expired/called.

	Approach 1 Cumulative balance $		Approach 2 Cumulative balance $		Difference
Assets					
Cash		**1,625,000**		**1,625,000**	
Receivable under Guarantee	14,625,000		14,625,000		
Discount on Receivable under Guarantee	(4,854,780)		(4,854,780)		
Allowance on Receivable under Guarantee			(5,000,000)		
Net Receivable under Guarantee		**9,770,220**		**4,770,220**	**5,000,000**
Liabilities					
Liability under Guarantee	(10,569,235)		(10,569,235)		
Net Liability under Guarantee		**(10,569,235)**		**(10,569,235)**	**(5,000,000)**
Income/Expense					
Guarantee Fee Revenue		**(556,275)**		**(556,275)**	
Interest Revenue		**(269,710)**		**(269,710)**	
Guarantee Risk Expense				**5,000,000**	

16. To carry the example further, let's assume that the borrower's risk rating remains the same for four periods, and over those same four periods, the guarantee remains in effect. Under Approach 1, there would be no further amortization of Liability under Guarantee. Under Approach 2, there would be no further amortization of the Discount on Receivable under Guarantee, since we have booked an Allowance on Receivable under Guarantee. The below tables shows the journal entries, balances in the various accounts and the impact of the difference between the 2 approaches.

	Journal Entry	Approach 1		Approach 2	
DR	Liability under Guarantee			1,668,825	
CR	Guarantee Fee Revenue				1,668,825
	(to release the guarantee liability and recognize revenue)				
DR	Cash	2,437,500		2,437,500	
CR	Receivable under Guarantee		2,437,500		2,437,500
	(to record the receipts of guarantee fee)				
DR	Discount on Receivable from Guarantee	809,130			
CR	Interest Revenue		809,130		
	(to amortize the discount on receivable from guarantee)				

	Approach 1 Cumulative balance $		Approach 2 Cumulative balance $		Difference
Assets					
Cash		**4,062,500**		**4,062,500**	
Receivable under Guarantee	12,187,500		12,187,500		
Discount on Receivable under Guarantee	(4,045,650)		(4,854,780)		
Allowance on Receivable under Guarantee			(5,000,000)		
Net Receivable under Guarantee		**8,141,850**		**2,332,720**	**5,809,130**
Liabilities					
Liability under Guarantee	(10,569,235)		(8,900,410)		
Net Liability under Guarantee		**(10,569,235)**		**(8,900,410)**	**(1,668,825)**
Income/Expense					
Guarantee Fee Revenue		**(556,275)**		**(2,225,100)**	**1,668,825**
Interest Revenue		**(1,078,840)**		**(269,710)**	**(809,130)**
Guarantee Risk Expense				**5,000,000**	**(5,000,000)**

17. Let's assume the borrower's risk rating deteriorates at the beginning of the Period 5 (before revenue recognition or the receipt of guarantee fee) such that the Guarantor decides a 25% reserve is now required, i.e., $12,500,000.

18. Under Approach 1, the Net Liability under Guarantee has a balance of $10,569,235. Therefore an additional liability of $ 1,930,765 should be recorded, in order to restate the total guarantee liability at $12,500,000, ie, the greater of the initially recognized liability and the newly assessed probable loss.

19. Under Approach 2, the Net Liability Under Guarantee has a balance of $8,900,410. Therefore, an additional guarantee liability of $3,599,590 should be booked, in order to restate the liability to $12,500,000, ie, the greater of the initially recognized liability and the newly assessed contingent loss. The additional provision expense of $3,599,590, would result in a total provision expense of $8,599,590. The actually assessed probable loss is $12,500,000. Therefore, an additional Allowance on Receivable under Guarantee of $3,900,410 is needed, so that a total of $12,500,000 of probable losses are booked to the income statement.

20. The below tables shows the journal entries, balances in the various accounts and the impact of the difference between the 2 approaches.

	Journal Entry	Approach 1		Approach 2	
DR	Guarantee Risk Expense	1,930,765		7,500,000	
CR	Allowance for Guarantee Risk		1,930,765		3,599,590
CR	Allowance on Receivable under Guarantee				3,900,410

	Approach 1 Cumulative balance $		Approach 2 Cumulative balance $		Difference
Assets					
Cash		**4,062,500**		**4,062,500**	
Receivable under Guarantee	12,187,500		12,187,500		
Discount on Receivable under Guarantee	(4,045,650)		(4,854,780)		
Allowance on Receivable under Guarantee			(8,900,410)		
Net Receivable under Guarantee		**8,141,850**		**(1,567,690)**	**9,709,540**
Liabilities					
Liability under Guarantee	(10,569,235)		(8,900,410)		
Allowance for Guarantee Risk	(1,930,765)		(3,599,590)		
Net Liability under Guarantee		**(12,500,000)**		**(12,500,000)**	
Income/Expense					
Guarantee Fee Revenue		**(556,625)**		**(2,225,100)**	**1,668,825**
Interest Revenue		**(1,078,840)**		**(269,710)**	**(809,130)**
Guarantee Risk Expense		**1,930,765**		**12,500,000**	**(10,569,235)**

21. At this point, we observe a negative receivable, under Approach 2, as shown by the above table.

22. Now, let us assume that the guarantee is called. The following tables show the journal entries and the balances in the various accounts subsequent to the call.

	Journal Entry	Approach 1		Approach 2	
DR	Loan	50,000,000		50,000,000	
CR	Cash		50,000,000		50,000,000
	(to record disbursement as a result of the call on the guarantee)				
DR	Liability under Guarantee	10,569,235		8,900,410	
DR	Allowance for Guarantee Risk	1,930,765		3,599,590	
DR	Discount on Receivable under Guarantee	4,045,650		4,854,780	
CR	Receivable under Guarantee		12,187,500		12,187,500
CR	Allowance for Loan Loss		4,358,150		(5,167,280)
	(to close all guarantee related accounts to Allowance for Loan Loss)				

	Approach 1 Cumulative balance $		**Approach 2 Cumulative balance $**		**Difference**
Assets					
Cash		**4,062,500**		**4,062,500**	
Receivable under Guarantee	12,187,500		12,187,500		
Discount on Receivable under Guarantee	(4,045,650)		(4,854,780)		
Allowance on Receivable under Guarantee			(8,900,410)		
Net Receivable under Guarantee		**8,141,850**		**(1,567,690)**	**9,709,540**
Liabilities					
Liability under Guarantee	(10,569,235)		(8,900,410)		
Allowance for Guarantee Risk	(1,930,765)		(3,599,590)		
Net Liability under Guarantee		**(12,500,000)**		**(12,500,000)**	
Income/Expense					
Guarantee Fee Revenue		**(556,625)**		**(2,225,100)**	**1,668,825**
Interest Revenue		**(1,078,840)**		**(269,710)**	**(809,130)**
Guarantee Risk Expense		**1,930,765**		**12,500,000**	**(10,569,235)**

23. The new loan will be assessed for impairment and if the balance in the Allowance for Loan Loss does not cover the impairment measured, an additional allowance will be booked via a charge to the Income Statement. This is true under both approaches. Since the balance in the Allowance for Loan Loss is lower under Approach 1, the charge to the Income Statement (if needed) will be higher under this method.

24. If a Guarantor were to follow Approach 1, the probable loss is recognized only when the guarantee liability is less than the assessed probable loss. This results in a non-recognition of the entire probable loss.

25. Under Approach 2, the Guarantor will measure the guarantee liability (subsequent to initial recognition) at the higher of (a) the amount determined in accordance with IAS 37 and (b) the amount initially recognized less, when appropriate, cumulative amortization recognized in accordance with IAS 18. This approach is similar to Approach 1. In addition, the Guarantor will recognize the full amount of the assessed probable loss by booking an Allowance for Receivable under Guarantee. However, under Approach 2, we have observed a situation where the receivable becomes negative (see paragraph 22 above). A receivable should be zero or greater than zero. However, to make the receivable zero, we would have to either (a) increase the guarantee liability by $1,567,690 or (b) to recognize Interest Revenue of $1,567,690. Increasing the guarantee liability is contrary to the ED and is therefore not

possible. Recognition of Interest Revenue of $1,567,690 cannot be justified, in the light of the fact, that we are recognizing a probable loss.

SUMMARY

26. Approach 1 does not recognize the full amount of probable loss. Approach 2 results in a negative receivable. Therefore, it appears that neither Approach 1 nor Approach 2 are appropriate.