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Friday 8th October, 2004

Amendments to IAS 39 and IFRS 4: Financial Guarantee Contracts and Credit Insurance

Dear Andrea,

ISDA appreciates this opportunity to comment on the Exposure Draft ("ED") of *'Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts, Financial Guarantee Contracts and Credit Insurance'* which was published by the International Accounting Standards Board ("IASB" or "the Board") in July 2004.

Our members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such we believe ISDA brings a unique and broad perspective to the IASB's work on accounting for financial instruments.

Key Messages:

- ISDA agrees with the proposal in the ED that the legal form of a contract should not affect the accounting treatment. It is our strongly held view that accounting standards should aim to consistently reflect the underlying economic substance of transactions.

- As such, in the longer term, once the accounting treatment for insurance contracts has been fully developed, ISDA believes that where a guarantee is, in substance, an insurance contact, it should be accounted for as an insurance contact, and where it is, in substance, a financial instrument, it should be accounted for in accordance with IAS 39. In the meantime, ISDA accepts that financial guarantee contracts will generally meet the IAS 37 definition of a contingent liability, and the IASB's proposal for subsequent measurement in accordance with IAS 37 therefore represents a pragmatic interim solution.

- However, ISDA recommends that the final standard allow entities to use the fair value option for financial guarantees. We would also encourage the IASB to reconsider its approach to the subsequent measurement of financial guarantees provided in conjunction with the sale of financial assets.

- ISDA also recommends that the final amendments clarify that they are only meant to be applied to the accounting for financial guarantees in the financial statements of the guarantor.

The appendix to this letter sets out our detailed answers to the questions posed by the Board. We would be pleased to discuss our comments with the Board or staff. Please contact Melissa Allen at CSFB on (020) 7883 3598 or Ed Duncan at ISDA on (020) 7330 3574.

Yours sincerely

Melissa Allen
Chair of the ISDA European Accounting Committee.

Ed Duncan
Assistant Director of European Policy at ISDA.

Appendix

We outline below our responses to the questions raised by the IASB in the invitation to comment.

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.

ISDA agrees with the proposal in the ED that the legal form of a contract should not affect the accounting treatment. The proposed approach would be consistent with the principles of "substance over form" and "faithful representation" identified by the IASB as Qualitative Characteristics of Financial Statements in its Framework for the Preparation and Presentation of Financial Statements.

Consistent with the application of substance over form, financial guarantee contacts should, in the longer term, once insurance accounting has been fully developed, be accounted for either as insurance contracts or as financial instruments, depending on their economic substance.

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?

ISDA believes that financial guarantees that are not in substance insurance contracts should be within the scope of IAS 39. Furthermore, until a standard on the measurement of insurance contracts is finalised, we concur with the Board's decision to include all financial guarantees within the scope of IAS 39.

Finally, we note from paragraph IN11 of the ED that the proposals are only meant to apply to the accounting for financial guarantees in the financial statements of the guarantor. ISDA would recommend that this be clarified in the final amendments to IAS 39, as it is currently unclear from the proposed wording.

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 18Revenue (see paragraph 47(c) of IAS 39).

Is this proposal appropriate? If not, what changes do you propose, and why?

ISDA agrees with the valuation principles proposed in the ED for the subsequent measurement of a financial guarantee other than those relating to the transfer of financial assets or liabilities. However, organisations often manage financial guarantees on a fair value basis and we would consider it more appropriate in these, as in other circumstances, that the revised standard allows an entity to use the fair value option.

The proposals also provide different subsequent measurement rules where the financial guarantee contract is entered into or retained on transferring to another party financial assets or financial liabilities, but we see no conceptual basis for requiring an inconsistent treatment, particularly where there is no continuing involvement with the transferred asset or liability. We therefore consider that in these circumstances the subsequent measurement of the instrument should be as required for all other financial guarantees.

Furthermore, ISDA continues to believe that the overall approach taken by the IASB towards derecognition and the subsequent measurement where the asset remains on the balance sheet does not represent an appropriate conceptual accounting basis. We would encourage the IASB to review the derecognition rules at the earliest opportunity and consult with both industry bodies and other standard setters to develop a solution that can be internationally applied. ISDA would be happy to contribute to such a project.

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.

Is the proposed effective date and transition appropriate? If not, what do you propose, and why?

ISDA agrees that the proposals should apply to periods beginning on or after 1 January 2006, with earlier application encouraged. We believe it is important that the IASB keeps its commitment to maintaining a stable platform of accounting standards during 2005 when many companies will be adopting IFRS for the first time.

Question 5 – Other comments

Do you have any other comments on the proposals?

ISDA has no further comments on the proposals.