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Your ref Financial Guarantee Contracts and Credit Insurance ED

Our ref EL/813

Contact Mark Vaessen
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8 October 2004

Dear Sir David

Exposure Draft of Amendments to IAS 39 and IFRS 4 – Financial Guarantee Contracts and Credit Insurance

We appreciate the opportunity to respond to the invitation to comment on the International Accounting Standards Board's exposure draft of its proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts *Financial Guarantee Contracts and Credit Insurance*. This letter expresses the views of KPMG International[1].

We appreciate the IASB's efforts to develop internationally accepted accounting standards with the intention to account for contracts with the same economic substance but different legal forms in the same manner. However, we are not convinced at this time whether a clear distinction can be made between financial guarantees, insurance contracts and guarantees bearing neither insurance nor financial risks. In addition, some other products, such as performance guarantees, have an identical risk profile but do not meet the definition of a financial guarantee and are therefore accounted for differently. We believe the distinctions between these types of contracts should be more fully explored before the Board introduces accounting requirements concerning some of the contracts only.

Furthermore, we believe that the scope of the ED creates new measurement problems for holders and issuers of reinsurance contracts. The ED's scope addresses only the accounting by the issuer of a financial guarantee contract. However the holder of such an instrument, for example a back-to back guarantee (reinsurance) arrangement entered into to cede some or all of the exposure created by an issued financial guarantee, would not be covered by the scope of this ED. The

[1] KPMG International is a Swiss cooperative that provides no client services. All professional services are performed by its member firms. As used herein, "KPMG" refers to KPMG International and/or its member firms, as appropriate.

reinsurance arrangement may receive a different subsequent measurement (i.e. the Phase I accounting allowed by IFRS 4) even though it mirrors the issued financial guarantee contract (subsequently measured under IAS 39).

In practice, banks and insurance companies use financial guarantees and reinsurance contracts to reduce their risk exposure. As part of their portfolio management, they are both issuers and holders of financial guarantees. In order to address this subsequent measurement mismatch, we see the need for clarification under which standard financial guarantee contracts held are accounted for.

We believe that the initial measurement is not clear as the ED, on the one hand indicates that the contract should be measured initially at its fair value at inception, being the premium received, and on the other hand refers to FIN 45 which requires determining the fair value by discounting all premiums received or receivable. We recommend clarifying how the expression of "premiums received" in the Exposure Draft should be interpreted.

In conclusion, we propose that the ED is currently withdrawn. We believe that the accounting treatment of financial guarantees needs further consideration and should therefore be dealt with in Phase II of the Insurance Project and the Financial Instruments Project which will allow for more time. Within these projects a clear distinction between financial guarantees, insurance contracts and other guarantees bearing neither insurance nor financial risk can be made to avoid financial engineering between financial guarantees, insurance contracts and credit derivatives. We believe that a solution in such a project should be found for the current prohibition for IFRS preparers from using the same accounting principles for financial guarantees issued and held.

In addition, we note that accounting for financial guarantee contracts using the liability adequacy test under IFRS 4 would result in a liability at least equal to the amount that would be recognised under IAS 37. Given the potentially significant cost of system changes for this specific item and the fact that the 2005 deadline is only months away, we would recommend to withdraw the present proposal and, instead, to clarify that credit insurance contracts are covered by IFRS 4.

Please find below our more detailed comments in answering the Board's questions set out in the ED.

Question 1: Form of contract

We strongly support the intention to account for contracts with the same economic substance in the same manner. In particular, the legal form of such contract should not affect its accounting treatment, thus preventing opportunities for "financial engineering".

At the moment, we believe that there are differences in the risk profile between some financial guarantees and some credit insurance contracts, but further economic analysis is required to consider whether such differences would justify a different accounting treatment. Within this economic analysis it should be considered that differences between financial guarantee contracts and credit insurance might arise, for example, from differences in contractual relationships, differences in cash flows and differences in the way the contracts are managed.

On the other hand, some performance guarantees have an identical risk profile to financial guarantees but they are not covered by this ED. In particular, banks issue guarantees which require the payment of a predetermined amount if the debtor fails to perform as agreed within a sales contract. Economically, this could be viewed as a guarantee for the payment amount but subject to repayment if goods are not delivered or the warranty is not fulfilled. Alternatively, it could be viewed as an insurance contract which provides payment in the event of the non-performance under the related contracts.

Therefore, we would recommend developing clear guidance for determining the economic substance of financial guarantee contracts and how to differentiate between financial guarantee contracts, insurance contracts and other guarantees. We believe this will require a substantial effort and therefore should be covered within Phase II of the Insurance Project or the Financial Instruments Project.

Question 2: Scope

In practice, banks and insurance companies use financial guarantee or reinsurance contracts as part of their portfolio management to reduce their risk exposure. They are therefore in the position of both a holder and an issuer of financial guarantee contracts or credit insurance contracts. The ED indicates that all financial guarantees should be within the scope of IAS 39 but defines a financial guarantee contract as "a contract that requires the **issuer** to make specified payments". Paragraph BC4 states that the holder of such a financial guarantee is not within the scope of the standard.

In our view, it is necessary that the amendment, which we recommend is considered as part of the Phase II or Financial Instrument Project, should address whether and how a matching effect can be achieved for risk offsetting position. We recommend clarifying if financial guarantees held are within the scope of IFRS 4, as reinsurance contracts held for credit insurance contracts are accounted for under IFRS 4.

Question 3: Subsequent measurement

We agree that the proposed measurement method for financial guarantees is appropriate, but we do not believe that it is consistent with IAS 39's measurement models of fair value or amortised cost. The proposed accounting is more consistent with the measurement model set out in IFRS 4, particularly the need for an IAS 37 floor. Therefore, given that such financial guarantees meet the definition of an insurance contract, we believe that IFRS 4 is the more appropriate standard to deal with the accounting for these contracts.

In addition, the ED proposes modifying the current IAS 39 to allow loan commitments to be voluntarily designated at fair value through profit and loss. If the IASB decides to go forward with this proposed amendment, we see no reason not to allow the same treatment for financial guarantees and credit insurance contracts if considered to be financial instruments within the scope of IAS 39. In particular, this would be beneficial in the situation described earlier where an entity enters into back-to-back guarantees (reinsurance contracts) used to offset their risks arising from financial guarantees issued. We recommend IAS 39 should specifically allow this.

For our concerns relating to the initial measurement see question 5.

Question 4: Effective date and transition

As discussed above we believe financial guarantees and credit insurance contracts need further economic analysis and therefore should be dealt with in Phase II of the Insurance Project and in the Financial Instruments Project.

Question 5: Other comments

The ED requires measuring financial assets and financial liabilities initially at fair value, which is consistent with the accounting treatment for other financial instruments. We support this view, however it is unclear whether the fair value is determined as the premium received or as the discounted amount of all premiums received and receivable as stated in FIN 45 to which the ED refers. The introduction of the ED points out that the fair value at inception is likely to equal the premium “received”, whereas FIN 45 requires the liability recognised at inception to equal the premium “received or receivable”.

The concept of FIN 45 introduces a requirement to split a contract into its two elements: a) an obligation to perform under the guarantee contract and b) a right to receive premiums. Those elements have to be recognised and measured separately. This concept is at odds with the current accounting concept in IAS 39 which requires recognising and measuring a contract in its entirety rather than in its elements. As neither FIN 45 nor this ED contain detailed requirements, we see the need for more guidance on the fair value measurement of financial guarantees.

In the context of FIN 45, we want to point out that the US GAAP rules might be helpful for the accounting of guarantees but guarantees issued by an insurance company are scoped out explicitly (FIN 45.6d). Since the scope of the proposals differs from the scope of FIN 45, it is doubtful whether consistency in accounting with FIN 45 would achieve real convergence.

Please contact Mark Vaessen at 020 7694 8089 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

KPMG International

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