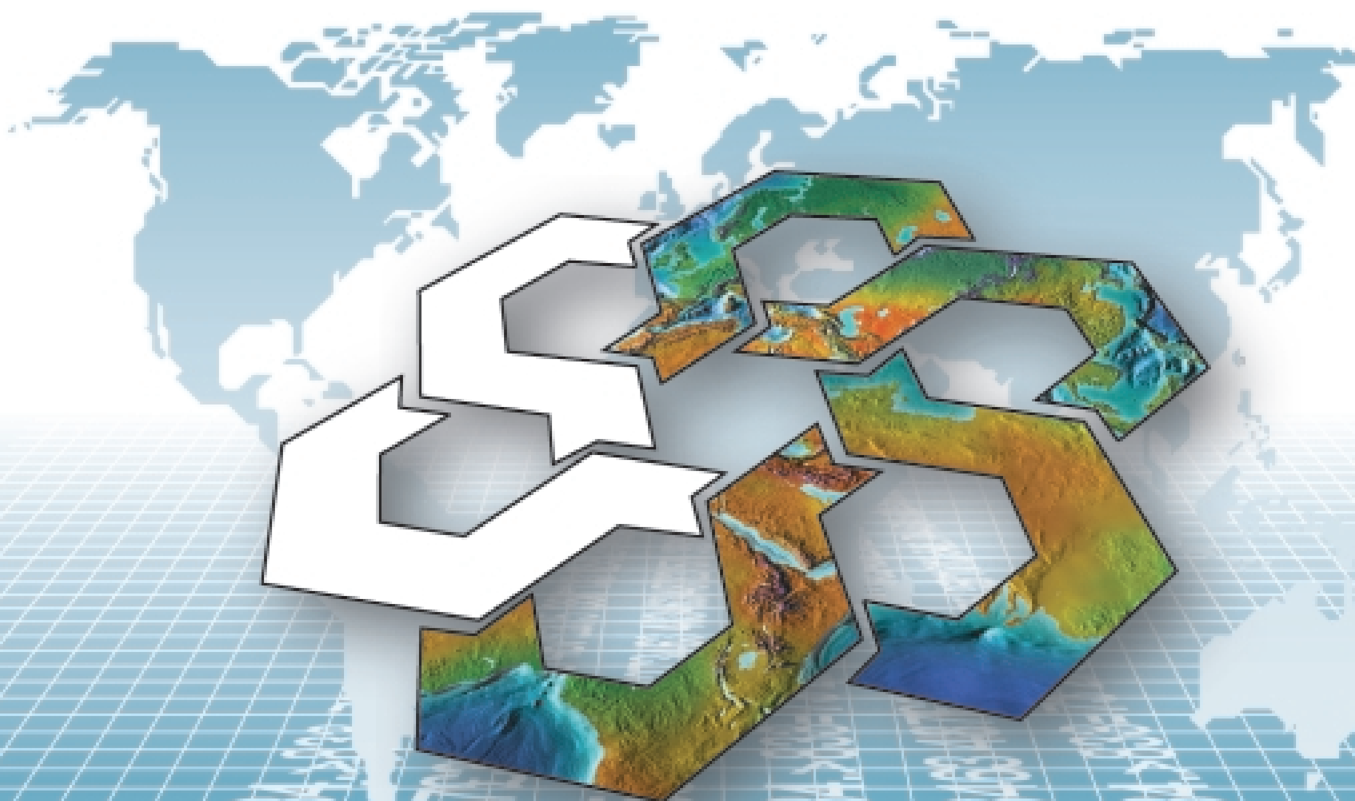
July 2004

EXPOSURE DRAFT OF PROPOSED

Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts

Financial Guarantee Contracts and Credit Insurance

Comments to be received by 8 October 2004



International Accounting Standards Board®

Exposure Draft of proposed

AMENDMENTS TO
IAS 39 FINANCIAL INSTRUMENTS:
RECOGNITION AND MEASUREMENT
AND
IFRS 4 INSURANCE CONTRACTS

FINANCIAL GUARANTEE CONTRACTS AND CREDIT INSURANCE

Comments to be received by 8 October 2004

This Exposure Draft of proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 4 *Insurance Contracts* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as amendments to IAS 39 and IFRS 4. Comments on the Exposure Draft and the Basis for Conclusions should be submitted in writing so as to be received by **8 October 2004**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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

Fax: +44 (0)20 7246 6411

The IASB, the International Accounting Standards Committee Foundation (IASCF), the authors and the publishers do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

Copyright © 2004 IASCF

ISBN: 1-904230-60-1

This document is published with two others proposing amendments to IAS 39. For the set comprising the three documents the ISBN is 1-904230-64-4.

All rights reserved. Copies of the draft Amendments and the accompanying documents may be made for the purpose of preparing comments to be submitted to the IASB, provided such copies are for personal or intraorganisational use only and are not sold or disseminated and provided each copy acknowledges the IASCF's copyright and sets out the IASB's address in full. Otherwise, no part of this publication may be translated, reprinted or reproduced or utilised in any form either in whole or in part or by any electronic, mechanical or other means, now known or hereafter invented, including photocopying and recording, or in any information storage and retrieval system, without prior permission in writing from the IASCF.

The IASB logo/"Hexagon Device", "*e*IFRS", "IAS", "IASB", "IASC", "IASCF", "IASs", "IFRIC", "IFRS", "IFRSs", "International Accounting Standards", "International Financial Reporting Standards" and "SIC" are Trade Marks of the IASCF.

Additional copies of this publication may be obtained from:
IASCF Publications Department
1st Floor, 30 Cannon Street, London EC4M 6XH, United Kingdom.
Tel: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749
Email: publications@iasb.org Web: www.iasb.org

Contents

	Page
INTRODUCTION	4
INVITATION TO COMMENT	6
PROPOSED AMENDMENTS TO IAS 39 AND IFRS 4	8
Proposed amendments to IAS 39	8
Proposed amendments to IFRS 4	14
Effective date and transition	17
Proposed consequential amendments	17
BASIS FOR CONCLUSIONS	19

 © Copyright IASCF

Introduction

IN1. Financial guarantee contracts (sometimes known as 'credit insurance') 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. These contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. Some financial guarantee contracts result in the transfer of significant insurance risk and thus meet the definition of 'insurance contract' in IFRS 4 *Insurance Contracts*.

IN2. This Exposure Draft contains proposals by the International Accounting Standards Board to amend IAS 39 *Financial Instruments: Recognition and Measurement* to define 'financial guarantee contracts' and amend the requirements for their treatment by the issuer. Under the proposals, the legal form of such contracts would not affect their accounting treatment.

IN3. The proposals would require the issuer of a financial guarantee contract (other than those contracts described in paragraph IN6) to measure the contract:

(a) initially at fair value. If the financial guarantee contract was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.

(b) subsequently at the higher of (i) the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

These requirements would apply even if the contract meets the definition of an insurance contract in IFRS 4.

IN4. For a stand-alone financial guarantee contract issued in an arm's length transaction to an unrelated party, the main practical effect of the proposals is the requirement to use IAS 37 to determine whether an additional liability should be recognised. Without the requirements proposed in this Exposure Draft, if the issuer carries out a liability

© Copyright IASCF

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.

IN5. The proposals could have a more significant effect for financial guarantee contracts that are not issued in an arm's length transaction to an unrelated party and for financial guarantee contracts embedded in other contracts.

IN6. Financial guarantee contracts that were entered into or retained on transferring financial assets or financial liabilities to another party would be measured:

(a) in accordance with paragraphs 29-37 and AG47-AG52 of IAS 39 if the financial guarantee contract prevents derecognition or results in continuing involvement; or

(b) as a derivative in all other cases.

IN7. The substance of the proposals is consistent with requirements included in the revised version of IAS 39 issued in December 2003. In finalising IFRS 4 in early 2004, the Board acknowledged the need to expose its conclusions in this area for comment. Pending completion of amendments resulting from this Exposure Draft, these financial guarantee contracts are within the scope of IFRS 4.

IN8. Although the scope section of IAS 39 excluded financial guarantee contracts from the scope of IAS 39, it specified their measurement. For clarity, the Exposure Draft proposes to address the measurement of these contracts in the measurement section of IAS 39, not in its scope section.

IN9. Similarly, the proposals in the Exposure Draft would transfer the requirements for measuring some loan commitments from the scope section of IAS 39 to its measurement section. However, the measurement basis for these loan commitments remains unchanged.

IN10. If confirmed in a Standard, the proposals in this Exposure Draft would apply for annual periods beginning on or after 1 January 2006. Earlier application would be encouraged.

IN11. This Exposure Draft does not address accounting by the holder of financial guarantee contracts. This subject is outside the scope of IFRS 4.

© Copyright IASCF

Invitation to Comment

The International Accounting Standards Board invites comments on the changes proposed in this Exposure Draft. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than **8 October 2004**.

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.

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?

© Copyright IASCF

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?

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?

Question 5 – Other comments

Do you have any other comments on the proposals?

 © Copyright IASCF

Proposed Amendments to IAS 39 and IFRS 4

In this Exposure Draft, the proposed amendments are shown with new text underlined and deleted text struck through.

Proposed amendments to IAS 39 (as previously amended by IFRS 4)

In the Introduction to IAS 39, paragraphs IN5 and IN6 are amended and paragraph IN5A is added.

IN5. The scope of the Standard includes financial guarantee contracts that were previously within the scope of IFRS 4 *Insurance Contracts*. A financial guarantee contract is defined 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. Financial guarantee contracts are initially recognised at fair value. Other than those described in paragraph IN5A, financial guarantee contracts are subsequently measured at the higher of (a) the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.~~The treatment of financial guarantee contracts has been reviewed. Such a contract is within the scope of this Standard if it is not an insurance contract, as defined in IFRS 4 *Insurance Contracts*. Furthermore, if an entity entered into, or retained, a financial guarantee on transferring to another party financial assets or financial liabilities within the scope of the Standard, the entity applies the Standard to that contract, even if the contract meets the definition of an insurance contract. The Board expects to issue in the near future an Exposure Draft proposing amendments to the treatment of financial guarantees within the scope of IFRS 4.~~

IN5A. Financial guarantee contracts that were entered into or retained on transferring to another party financial assets or financial liabilities within the scope of this Standard are subsequently measured:

(a) in accordance with paragraphs 29-37 and AG47-AG52 of IAS 39 if the financial guarantee contract prevents derecognition or results in continuing involvement; or

© Copyright IASCF

(b) as a derivative in all other cases.

IN6. A ~~second~~ scope exclusion has been ~~added~~ made for loan commitments that are not classified as at fair value through profit or loss and cannot be settled net. A commitment to provide a loan at a below-market interest rate is initially recognised at fair value, and subsequently measured at the higher of (a) the amount that would be recognised under IAS 37 and (b) the amount initially recognised less, ~~where~~ when appropriate, cumulative amortisation recognised in accordance with IAS 18 ~~*Revenue*~~.

In the Standard, paragraphs 2(e), 2(h), 4, 47 and AG4A are amended and paragraph 3 is deleted. In paragraph 9, a new definition is added immediately after the definition of a derivative, and the definition of a financial liability at fair value through profit or loss is amended as set out below. Paragraph 43 is included here for reference, but is not amended.

The amendments to paragraphs 2(h) and 47(d) would transfer measurement requirements for some loan commitments from the scope section of the Standard to the measurement section, but would not change those requirements.

2. This Standard shall be applied by all entities to all types of financial instruments except:

…

(e) rights and obligations arising under (i) an insurance contract as defined in IFRS 4 **Insurance Contracts*****, other than an insurance contract that meets the definition of a financial guarantee contract in paragraph 9, or (ii)*** ~~***under***~~ ***a contract that is within the scope of IFRS 4 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of IFRS 4 if the derivative is not itself a contract within the scope of IFRS 4 (see paragraphs 10-13 and Appendix A paragraphs AG23-AG33).*** ~~***Furthermore, if an insurance contract is a financial guarantee contract entered into, or retained, on transferring to another party financial assets or financial liabilities within the scope of this Standard, the issuer shall apply this Standard to the contract (see paragraph 3 and Appendix A paragraph AG4A).***~~

 © Copyright IASCF

…

(h) ***~~except as described in paragraph 4, loan commitments that cannot be settled net in cash or another financial instrument. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction). An issuer of a commitment to provide a loan at a below-market interest rate shall initially recognise it at fair value, and subsequently measure it at the higher of (i) the amount recognised under IAS 37 and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18.~~*** *loan commitments other than those loan commitments described in paragraph 4.* ***An issuer of loan commitments shall apply IAS 37 to ~~other~~ loan commitments that are not within the scope of this Standard. ~~Loan~~*** *However, all loan* ***commitments are subject to the derecognition provisions of this Standard (see paragraphs 15-42 and Appendix A paragraphs AG36-AG63).***

~~3. Some financial guarantee contracts require 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 under the original or modified terms of a debt instrument. If that requirement transfers significant risk to the issuer, the contract is an insurance contract as defined in IFRS 4 (see paragraphs 2(e) and AG4A). Other financial guarantee contracts require payments to be made in response to changes in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. Such contracts are within the scope of this Standard.~~

3. [Deleted]

4. The following loan commitments are within the scope of this Standard:

(a) ***~~Loan~~ loan commitments that the entity designates as financial liabilities at fair value through profit or loss ~~are within the scope of this Standard~~. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.***

(b) ***loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction).***

(c) ***commitments to provide a loan at a below-market interest rate. Paragraph 47(d) specifies the subsequent measurement of liabilities arising from these loan commitments.***

9. ***…***

Definition of a Financial Guarantee Contract

A financial guarantee contract is 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.

Definitions of Four Categories of Financial Instruments

A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.

(a) ***It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:***

…

(iii) ***a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).***

…

 © Copyright IASCF

Initial Measurement of Financial Assets and Financial Liabilities

43. ***When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.***

Subsequent Measurement of Financial Liabilities

47. ***After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:***

(a) financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a financial guarantee contract (which shall be measured in accordance with (c)) or a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured (which shall be measured at cost).

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or is accounted for using the continuing involvement approach. Paragraphs 29 and 31 apply to the measurement of such financial liabilities.

(c) financial guarantee contracts as defined in paragraph 9, other than those that were entered into or retained on transferring to another party financial assets or financial liabilities within the scope of this Standard (see also Appendix A paragraph AG4A). After initial recognition, an issuer of a financial guarantee contract that was not entered into or retained on transferring to another party financial assets or financial liabilities within the scope of this Standard shall measure it at the higher of:

(i) the amount determined in accordance with IAS 37 **Provisions, Contingent Liabilities and Contingent Assets;** ***and***

***(ii)** the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18* **Revenue.**

***(d)** commitments to provide a loan at a below-market interest rate. After initial recognition, the issuer of such a commitment shall measure it at the higher of:*

***(i)** the amount determined in accordance with IAS 37; and*

***(ii)** the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18.*

Financial liabilities that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 89-102.

AG4A. Financial guarantee contracts may have various legal forms, such as a financial guarantee, letter of credit, credit default contract or insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph~~s~~ 2(e) ~~and 3~~):

(a) Although a financial guarantee contract meets the definition of ~~If the contract is not~~ an insurance contract~~, as defined~~ in IFRS 4, the issuer applies this Standard. ~~Thus, a financial guarantee contract that requires payments if the credit rating of a debtor falls below a particular level is within the scope of this Standard.~~ Paragraph 43 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently:

(i)~~(b)~~ ~~If the issuer incurred~~ unless the financial guarantee contract was entered into or retained ~~the financial guarantee~~ on transferring to another party financial assets or financial liabilities within the scope of this Standard, the issuer ~~applies this Standard~~ measures it at the higher of:

- the amount determined in accordance with IAS 37; and

 © Copyright IASCF

- the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 (see paragraph 47(c)).

(ii) if the financial guarantee contract was entered into or retained on transferring to another party financial assets or financial liabilities within the scope of this Standard, the issuer measures it:

- in accordance with paragraphs 29-37 and AG47-AG52 of this Standard if the financial guarantee contract prevents derecognition or results in continuing involvement; and
- as a derivative in all other cases.

~~(c) If the contract is an insurance contract, as defined in IFRS 4, the issuer applies IFRS 4 unless (b) applies.~~

(~~d~~b) If ~~the issuer gave~~ a financial guarantee contract is issued in connection with the sale of goods, the issuer applies IAS 18 in determining when it recognises the ~~resulting~~ revenue from the guarantee and from the sale of goods.

(c) If a credit guarantee (eg a contract that requires payments if the credit rating of a debtor falls below a particular level) meets neither the definition of a financial guarantee contract in this Standard nor the definition of an insurance contract in IFRS 4, the issuer applies this Standard. Such a contract is a derivative.

Proposed amendments to IFRS 4

In the Introduction to IFRS 4, a reference to credit insurance contracts is inserted in paragraph IN3.

IN3 The IFRS applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs (eg credit insurance contracts that meet the definition of a financial guarantee contract in IAS 39 *Financial Instruments: Recognition and Measurement*). It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of IAS 39 ~~*Financial Instruments: Recognition and Measurement*~~. Furthermore, it does not address accounting by policyholders.

Paragraphs 4(d), B18(g) and B19(f) are amended as follows.

4 An entity shall not apply this IFRS to:

…

(d) financial guarantee~~s~~ contracts as defined in IAS 39 ~~that an entity enters into or retains on transferring to another party financial assets or financial liabilities within the scope of IAS 39, regardless of whether the financial guarantees are described as financial guarantees, letters of credit or insurance contracts (see IAS 39)~~.

B18 The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:

…

(g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. These contracts could have various legal forms, such as that of a financial guarantee, letter of credit, credit derivative default ~~product~~ contract or insurance contract. ~~However, these contracts are outside the scope of this IFRS if the entity entered into them, or retained them, on transferring to another party financial assets or financial liabilities within the scope of IAS 39 (see paragraph 4(d)).~~ However, although these contracts meet the definition of an insurance contract, they also meet the definition of a financial guarantee contract in IAS 39 and are within the scope of IAS 32 and IAS 39, not this IFRS (see paragraph 4(d)).

B19 The following are examples of items that are not insurance contracts:

…

(f) a ~~financial~~ guarantee ~~contract~~ (or letter of credit, credit derivative default product or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (see IAS 39).

 © Copyright IASCF

In the *Guidance on Implementing IFRS 4*, IG Examples 1.11 and 1.12 are amended.

IG Example 1: Application of the definition of an insurance contract	
Contract type	*Treatment in phase I*
1.11 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 under the original or modified terms of a debt instrument. The contract may have various legal forms (eg insurance contract, ~~financial~~ guarantee or letter of credit).	Insurance contract, but within the scope of IAS 39, not this IFRS. ~~Within the scope of the IFRS, unless the contract was entered into or retained on the transfer of financial assets or financial liabilities within the scope of IAS 39.~~ ~~If the issuer's accounting policies do not require it to recognise a liability at inception, the liability adequacy test in paragraphs 15-19 of the IFRS may be particularly relevant.~~ The legal form of the contract does not affect its recognition and measurement.
1.12 A credit-related ~~financial~~ guarantee that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a contract is one that requires payments in response to changes in a specified credit rating or credit index.	Not an insurance contract. Within the scope of IAS 39.

© Copyright IASCF

Effective date and transition

The Board proposes that an entity should apply the proposed requirements in this Exposure Draft (if confirmed in a Standard) for annual periods beginning on or after 1 January 2006. Earlier application would be encouraged. If an entity applies these changes for an earlier period, it would be required to disclose that fact.

The proposed requirements would apply retrospectively, as described in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Proposed consequential amendments

IAS 32 *Financial Instruments: Disclosure and Presentation*

Paragraphs 4(d) and 12 are amended as follows.

4. ***This Standard shall be applied by all entities to all types of financial instruments except:***

   …

   (d) insurance contracts as defined in IFRS 4 **Insurance Contracts** ***other than insurance contracts that are also financial guarantee contracts as defined in IAS 39. However, this Standard applies to derivatives that are embedded in insurance contracts if IAS 39 requires the entity to account for them separately.***

12. The following terms are defined in paragraph 9 of IAS 39 and are used in this Standard with the meaning specified in IAS 39.

    - amortised cost of a financial asset or financial liability
    - available-for-sale financial assets
    - derecognition
    - derivative
    - effective interest method
    - financial asset or financial liability at fair value through profit or loss
    - financial guarantee contract
    - firm commitment

 © Copyright IASCF

- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held-to-maturity investments
- loans and receivables
- regular way purchase or sale
- transaction costs.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

In Appendix C, example 9, the second paragraph (inserted in 2004 by IFRS 4) is deleted.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

Introduction

BC1. This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in the Exposure Draft of proposed *Amendments to* IAS 39 *Financial Instruments: Recognition and Measurement and* IFRS 4 *Insurance Contracts* relating to *Financial Guarantee Contracts and Credit Insurance.* Individual Board members gave greater weight to some factors than to others.

BC2. Financial guarantee contracts may take various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. This Exposure Draft proposes to define a 'financial guarantee contract' as a contract that requires 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.

BC3. If the risk transfer resulting from a financial guarantee contract is significant, the contract meets the definition of an insurance contract in IFRS 4. Nevertheless, this Exposure Draft proposes that all financial guarantee contracts should be within the scope of IAS 39 and measured initially at fair value. Subsequently:

(a) financial guarantee contracts that were not entered into or retained on transferring to another party financial assets or financial liabilities would be measured at the higher of:

(i) the amount determined in accordance with IAS 37; and

(ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18.

 © Copyright IASCF

(b) financial guarantee contracts that were entered into or retained on transferring to another party financial assets or financial liabilities would be measured:

  (i) in accordance with paragraphs 29-37 and AG47-AG52 of IAS 39 if the financial guarantee contract prevents derecognition or results in continuing involvement; or

  (ii) as a derivative in all other cases.

BC4. This Exposure Draft deals with the treatment of financial guarantee contracts by the issuer. It does not address their treatment by the holder.

Background

BC5. The Board's discussions on financial guarantee contracts in the following documents are summarised below:

(a) June 2002 Exposure Draft of amendments to IAS 39

(b) ED 5 *Insurance Contracts*

(c) December 2003 revisions to IAS 39

(d) IFRS 4 *Insurance Contracts*.

June 2002 Exposure Draft of amendments to IAS 39

BC6. The Board addressed financial guarantee and similar contracts in June 2002 when it published an Exposure Draft of amendments to IAS 39. At that time, the following contracts were already within the scope of IAS 39 and the Board concluded that they should remain so:

(a) a financial guarantee contract given or retained by a transferor when it derecognises financial assets or financial liabilities.

(b) a financial guarantee contract that does not meet the definition of an insurance contract.

BC7. Other financial guarantee contracts were within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The Exposure Draft of June 2002 proposed that IAS 39 should deal with all financial guarantees at initial recognition, but that the subsequent measurement of some financial guarantee contracts should remain within the scope of IAS 37. The objective of this amendment was to clarify that issuing a financial guarantee contract creates a liability that

© Copyright IASCF

should be recognised. IAS 37 would require the contracts to be measured at the amount an entity would rationally be expected to pay to settle the obligation or to transfer it to a third party.

ED 5 *Insurance Contracts*

BC8. Subsequently, the Board began to develop ED 5 *Insurance Contracts*. Some took the view that the scope of IAS 39 should include all contracts that provide cover against credit risk, on the following grounds:

(a) Although credit insurers manage credit risk by pooling individual risk within a portfolio, banks also do this in managing the credit risk in a portfolio of financial guarantees. Although banks may rely more on collateral, this is no reason to require a different accounting treatment.

(b) Banks manage credit risk embedded in their financial assets, and there is no reason to require them to apply a different standard to credit risk embedded in financial guarantees.

(c) Credit risk is commonly traded in capital markets, even if the specific forms of credit risk embedded in some forms of credit insurance are not traded.

(d) As noted above, some financial guarantee contracts were already within the scope of IAS 39. To ensure consistent reporting, the scope of IAS 39 should include all contracts that provide protection against similar exposures.

BC9. Others argued that insurance against credit risk is different from a financial guarantee contract and should be within the scope of IFRS 4, on the following grounds:

(a) Insurance against credit risk is often arranged by the seller of goods and protects the seller against default by the buyer. The fact that default is generally outside the control of the seller, and so is fortuitous, allows the use of stochastic methods to estimate future cash flows arising from the contract, because they are random and not subject to moral hazard. By contrast, some financial guarantees, such as some letters of credit, are arranged at the request of the party whose obligation is being guaranteed. Default on such financial guarantee contracts is partly under the control of that party.

 © Copyright IASCF

(b) Insurance against credit risk is part of an insurer's overall insurance activity, and is managed as part of a diversified portfolio in the same way as other insurance activities.

(c) A credit insurer may refuse to pay a claim if the policyholder did not give full disclosure and may delay payment while a claim is investigated, whereas a guarantor is often required to pay on first notice of a default.

(d) A credit insurer faces risks similar to those arising in some other insurance contracts. For example, an insurance contract may require payments (either to the debtor or to the creditor) if a debtor's income is reduced by specified adverse events such as unemployment or illness, regardless of whether the debtor continues to make loan payments when due. The same adverse events may trigger payments on a financial guarantee contract.

(e) Including these contracts within the scope of IAS 39 would compel credit insurers to change their accounting immediately, unlike issuers of other types of insurance contracts. Furthermore, some credit insurance contracts contain features, such as cancellation and renewal rights and profit-sharing features, that the Board will not resolve until phase II of its project on insurance contracts.

BC10. ED 5 proposed in July 2003 that the contracts described in paragraph BC2 should be subject to the same requirements as all other insurance contracts.

BC11. Insurers generally agreed with ED 5 in this area. However, bank respondents typically opposed the proposals in ED 5, arguing that financial guarantees should remain within the scope of IAS 39 or IAS 37, on the following grounds:

(a) Financial guarantee contracts that provide for specified payments to reimburse the holder for a loss because a specified debtor fails to make payment when due should not be viewed as insurance contracts or derivatives. Although there are similarities to insurance contracts, there are also similarities to the management of credit risk in banks (see paragraph BC8).

© Copyright IASCF

(b) ED 5 did not indicate precisely what the accounting treatment should be for issued financial guarantee contracts within its scope, except for the proposed loss recognition test (subsequently relabelled in IFRS 4 as the liability adequacy test). Consequently, it would not be clear whether issued financial guarantee contracts within the scope of ED 5 (rather than IAS 39) should be initially measured at fair value.

(c) If viewed as an insurance product, these financial guarantees may be measured at fair value in phase II of the project on insurance contracts, which bank respondents regarded as less appropriate than applying IAS 37.

BC12. ED 5 proposed that financial guarantees incurred or retained on derecognition of a non-financial asset or non-financial liability should be treated in the same way as financial guarantees incurred or retained on derecognition of a financial asset or financial liability (ie they would be within the scope of IAS 39). However, no respondents commented on the substance of this proposal, and entities responding to ED 5 were not the entities most likely to be affected by this proposal. Therefore, the Board deleted this proposal in finalising IFRS 4, so that such contracts are within the scope of IFRS 4, pending the outcome of this Exposure Draft.

December 2003 revisions to IAS 39

BC13. Some respondents to the June 2002 Exposure Draft of amendments to IAS 39 expressed concern that applying IAS 37 after initial recognition would result in individual financial guarantee contracts being measured at nil immediately after initial recognition if the probability threshold in IAS 37 was not met, and thus the entity would recognise an immediate gain.

BC14. To address this concern, the Board clarified in the revised IAS 39 that the issuer of the financial guarantees described in paragraph BC2 (in effect, those that meet the definition of an insurance contract) should recognise them initially at fair value, and measure them subsequently at the higher of (a) the amount determined in accordance with IAS 37 and (b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*. The Board issued the revised IAS 39 in December 2003.

© Copyright IASCF

BC15. The Board deferred detailed consideration of financial guarantee contracts to its deliberations on ED 5.

IFRS 4 *Insurance Contracts*

BC16. In finalising IFRS 4 in early 2004, the Board reached the following conclusions:

(a) Financial guarantee contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. However, although this difference in legal form may be associated in some cases with differences in substance, the accounting for these instruments should not depend on their legal form.

(b) If a financial guarantee contract is not an insurance contract, as defined in IFRS 4, it should be within the scope of IAS 39.

(c) If a financial guarantee contract was entered into or retained on transferring to another party financial assets or financial liabilities within the scope of IAS 39, the issuer should apply IAS 39 to that contract even if the contract is an insurance contract, as defined in IFRS 4.

(d) Unless (c) applies, the measurement described in the revision of IAS 39 of December 2003 (see paragraph BC14) is appropriate for a financial guarantee contract that meets the definition of an insurance contract. However, the Board acknowledged the need to expose this conclusion for comment. Mindful of the need to develop a 'stable platform' of Standards for 2005, the Board decided to finalise IFRS 4 without specifying the accounting for these contracts and to develop this Exposure Draft. Pending amendments resulting from this Exposure Draft, IFRS 4 treats these contracts in the same way as other insurance contracts (as proposed in ED 5).

(e) If a guarantee was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.

(f) As noted in paragraph BC12, when the Board finalised IFRS 4, it deleted the proposal that guarantees incurred or retained on derecognition of a non-financial asset or non-financial liability should be treated in the same way as guarantees incurred or

© Copyright IASCF

retained on derecognition of a financial asset or financial liability. Pending the outcome of this Exposure Draft, it follows that guarantees incurred or retained on the transfer of a non-financial asset are within the scope of IFRS 4 if they meet the definition of an insurance contract. Among other things, this means that the guarantee is subject to the liability adequacy test described in paragraphs 15-19 of IFRS 4.

BC17. The Board decided to publish this Exposure Draft for the reasons in paragraph BC16(d).

Arguments for not publishing the Exposure Draft

BC18. Some suggested two reasons for not making the changes proposed in this Exposure Draft, in addition to those reasons given in paragraph BC9:

(a) Some argue that IAS 37 requires entities to determine adjustments for risk for each contract individually and that this leads to excessive risk margins when a portfolio of similar contracts is considered as a whole. However, the Board sees no basis for the assertion that IAS 37 requires an assessment contract by contract.

(b) Some argue that the decision to apply this model to these contracts in phase I prejudges the outcome of phase II for other insurance contracts. However, the Board emphasises that this is not the case.

BC19. Additionally, some suggested that the Board should not change the requirements for credit insurance contracts at this stage because IFRS 4 permits insurers to continue most aspects of their existing accounting for all other types of insurance contract, pending further work on phase II of the project. Paragraphs BC20-BC22 set out the Board's response to this suggestion.

BC20. The Board noted that, before the amendments proposed in this Exposure Draft, IFRS 4 applies as follows to these contracts:

(a) The issuer may continue using its existing accounting policies for these contracts, unless they conflict with the requirements of paragraphs 14-20 of IFRS 4. One such conflict could be the recognition of catastrophe or equalisation provisions, which paragraph 14(a) prohibits. Paragraphs BC23 and BC24 below give more detail on existing practices.

 © Copyright IASCF

(b) Unless the issuer applies a liability adequacy test that meets the minimum requirements in paragraph 16 of IFRS 4, it must perform a comparison with the amount determined by IAS 37 (in other words, a comparison similar to that proposed in this Exposure Draft). The liability adequacy test may be particularly relevant if the issuer's accounting policies would not otherwise require it to recognise a liability at the inception of the contract.

(c) The issuer could improve its accounting policies for such contracts if those improvements meet the criteria in paragraphs 21-30 of IFRS 4.

BC21. In addition, the Board noted that the main practical effects of the proposals in this Exposure Draft, if confirmed, are likely to be the following:

(a) All entities issuing financial guarantee contracts would recognise a liability at inception and measure it at that time at its fair value. For a stand-alone financial guarantee contract issued in an arm's length transaction to an unrelated party, this requirement is unlikely to change existing practice significantly.

(b) For subsequent measurement, an arm's length fee received for a stand-alone financial guarantee contract would be recognised as income over the period of the underlying risk exposure. For such financial guarantee contracts, this is unlikely to change existing practice significantly.

(c) The issuer would use IAS 37 to determine whether an additional liability should be recognised. Without the requirements proposed in this Exposure Draft, the issuer would carry out a liability adequacy test to comply with paragraphs 15-19 of IFRS 4. If that test did not meet the minimum requirements in paragraph 16 of IFRS 4, the issuer would use IAS 37 to determine whether an additional liability should be recognised. The minimum requirements in paragraph 16 of IFRS 4 are the following:

(i) the test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees.

© Copyright IASCF

(ii) if the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss.

BC22. To counter the view that IFRSs (and specifically IAS 37) do not require an entity to recognise a liability when it issues a financial guarantee contract, the Board concluded that it should publish this Exposure Draft now and not wait for further work on phase II of the Insurance project.

Review of other accounting treatments

BC23. The treatment proposed in this Exposure Draft has some similarities with existing accounting models used by issuers of financial guarantees and credit insurance contracts, and some differences. Some credit insurers use an 'accident year' model, with the following features:

(a) *At inception, premiums received are recognised as deferred income (unearned premium).* The proposals in the Exposure Draft would have a similar effect for a stand-alone financial guarantee contract issued in an arm's length transaction to an unrelated party.

(b) *Deferred premiums are recognised as revenue over the period of the underlying risk exposure.* The proposals in the Exposure Draft would have a similar effect.

(c) *Costs of originating the contract (often called 'acquisition costs') are deferred and amortised on a basis that reflects the underlying risk exposure*. The proposals in the Exposure Draft would require the issuer to deduct transaction costs, as defined in IAS 39, in determining the initial carrying amount of the liability. Instead of being recognised as an expense, those transaction costs would result in additional interest expense over the life of the contract. That interest expense would be determined using the effective interest method described in IAS 39. If acquisition costs do not meet the definition of transaction costs in IAS 39, they would be recognised as an expense when incurred.

(d) *If estimated payments under a contract (or, perhaps, a portfolio of contracts) exceed the deferred premiums, an additional liability is recognised.* The proposals in the Exposure Draft would have a similar effect, although there could be some difference in application because IAS 37 requires a

 © Copyright IASCF

measurement that reflects the time value of money (which some existing models do not) and includes an adjustment for risk and uncertainty (which may differ from the basis used, if any, by existing models).

(e) *If the period of the underlying risk exposure has passed, but payments are still foreseen, a liability is recognised.* The proposals in the Exposure Draft would have a similar effect, although there could be some difference in application because IAS 37 considers the time value of money and risk and uncertainty.

BC24. Some other credit insurers use an 'underwriting year' model, with the following features:

(a) *At inception, premiums received are recognised as revenue. At the same time, a liability is recognised to reflect the estimated payments under the contract.* The proposals in the Exposure Draft would have a similar effect for the measurement of a stand-alone financial guarantee issued in an arm's length transaction to an unrelated party. However, to comply with IAS 18, the premiums would be recognised as revenue over time as the liability recognised at inception is amortised.

(b) *The liability is adjusted as estimates of the payments change.* The proposals in the Exposure Draft would have a similar effect, although there could be some difference in application because IAS 37 considers the time value of money and risk and uncertainty.

Comparison with US GAAP

BC25. The US Financial Accounting Standards Board (FASB) has issued guidance that may be of interest to respondents to this Exposure Draft. The guidance is in FASB Interpretation 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). Relevant features of FIN 45 include the following:

(a) One of the FASB's main reasons for developing FIN 45 was to counter the belief of some that SFAS 5 *Accounting for Contingencies* prohibited a guarantor from recognising a liability for a guarantee issued if it is not probable that payments will be required under that guarantee.

© Copyright IASCF

(b) FIN 45 clarifies that a guarantor is required to recognise, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee (or, if greater, the measurement required by SFAS 5). When a guarantee is issued in a stand-alone arm's length transaction with an unrelated party, the liability recognised at inception should be the premium received or receivable.

(c) FIN 45 does not prescribe the method for the subsequent measurement of the guarantor's liability for its obligations under the guarantee. In commenting on current practices, FIN 45 notes that the liability recognised (initially at fair value) would typically be reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee (i) only upon either expiration or settlement of the guarantee, (ii) by a systematic and rational amortisation method, or (iii) as the fair value of the guarantee changes (eg for guarantees accounted for as derivatives). However, FIN 45 does not provide the criteria for determining when each of those methods would be appropriate. In addition, SFAS 5 applies to the contingent liability related to the contingent loss for the guarantee.

(d) FIN 45 does not apply to guarantees issued by an insurance company or a reinsurance company and accounted for in accordance with FASB statements specific to the insurance sector (SFASs 60, 97, 113 and 120).

(e) The recognition and measurement requirements of FIN 45 do not apply to guarantees issued either between parents and their subsidiaries, between corporations under common control, or by a parent or subsidiary on behalf of a subsidiary or the parent.

(f) The transitional provisions in FIN 45 require prospective application, to guarantees issued or modified after 31 December 2002.

(g) FIN 45 requires specific disclosures about guarantees to be given.

 © Copyright IASCF

BC26. The proposals in this Exposure Draft are consistent with FIN 45 in some areas, but differ in others:

(a) Like FIN 45, this Exposure Draft proposes initial recognition at fair value. The IASB agrees with the conclusion in FIN 45 that the fair value, at inception, of a financial guarantee contract issued in a stand-alone arm's length transaction with an unrelated party is likely to be equal to the premium received.

(b) The Exposure Draft proposes systematic amortisation, in accordance with IAS 18, of the liability recognised initially. This is compatible with FIN 45. Both the Exposure Draft and FIN 45 include a liability adequacy (or loss recognition) test, although the tests differ because of underlying differences in the Standards to which those tests refer (IAS 37 and SFAS 5).

(c) Unlike FIN 45, the Exposure Draft does not propose a different treatment for financial guarantee contracts issued by insurers. In the Board's view, distinctions based on the nature of the parties issuing a financial guarantee contract would make financial statements less relevant and reliable than distinctions (if any are required) based on the nature of the transaction.

(d) Unlike FIN 45, the Exposure Draft does not propose exemptions for parents, subsidiaries or other entities under common control. However, the Board noted that differences, if any, would be reflected only in the separate or individual financial statements of the parent, subsidiaries or common control entities, and that the amount recognised in consolidated financial statements would be the same under both FIN 45 and the proposals in the Exposure Draft.

(e) The Exposure Draft does not propose specific disclosure requirements about financial guarantee contracts, but relies on existing disclosure requirements in IAS 32. A proposed consequential amendment would bring these contracts within the scope of IAS 32.

Effective date and transition

BC27. The Board concluded that no specific transitional requirements should be proposed. The Board noted that the steps required for entities to apply the proposals would be (a) to establish the initial carrying amount,

© Copyright IASCF

(b) to amortise the initial carrying amount and (c) to measure the liability in accordance with IAS 37 (if the liability is higher than the amortised initial carrying amount).

BC28. Although step (c) may involve the use of hindsight if a timely assessment had not previously been made, none of these requirements is likely to be onerous because:

(a) entities already applying IFRSs should have applied IAS 37 in accounting for the liability and should be accounting for the fee received in accordance with IAS 18.

(b) first-time adopters that begin planning on a timely basis for the transition to IFRSs would not need to apply an unacceptable level of hindsight.

Therefore, the Board concluded that the proposed amendments should be applied retrospectively. Similarly, the Board concluded that there was no reason to provide an extended transition period.

© Copyright IASCF