FASB Emerging Issues Task Force

Issue No. 08-5

Title: Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement

Document: Issue Summary No. 1, Supplement No. 1*

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FASB Staff: Mills (ext. 317)/Maples (ext. 462)

EITF Liaison: Matthew Schroeder

Date previously discussed: June 12, 2008

Previously distributed EITF materials: Issue Summary No. 1, dated June 4, 2008

References:

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133)

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

FASB Statement No. 157, *Fair Value Measurements* (FAS 157)

FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159)

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46R)

* **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Proposed FSP FAS 157-c, *Measuring Liabilities under FASB Statement No. 157* (proposed FSP FAS 157-c)

APB Opinion No. 21, *Interest on Receivables and Payables* (APB 21)

IASB Discussion Paper, *Reducing Complexity in Reporting Financial Instruments* (IASB Discussion Paper on Complexity)

Statement 133 Implementation Issue No. B3, "Investor's Accounting for a Put or Call Option Attached to a Debt Instrument Contemporaneously with or Subsequent to Its Issuance" (DIG Issue B3)

Statement 133 Implementation Issue No. K3, "Determination of Whether Combinations of Options with the Same Terms Must Be Viewed as Separate Option Contracts or as a Single Forward Contract" (DIG Issue K3)

Background

1. At the June 12, 2008 EITF meeting, the Task Force reached a consensus-for-exposure that the issuer of a liability with a third-party credit enhancement (that is, a guarantee) that is inseparable from the liability (for example, debt) shall not include the effect of the credit enhancement in the fair value measurement of the liability and directed the FASB staff to issue a draft abstract for public comment. The draft abstract was posted to the FASB website on July 1, 2008, with a comment period that ended August 4, 2008. The three comment letters received on the draft abstract have previously been distributed to Task Force members and have been analyzed by the staff below. At the September 10, 2008 EITF meeting, the Task Force will have the opportunity to consider the comment letters and informal comments that the staff received and has analyzed below, as it redeliberates the consensus-for-exposure. The Task Force will then be asked whether it agrees with the staff recommendations for the proposed changes to the draft abstract, which is attached as Appendix 08-5A (added text is underlined and deleted text is ~~struck out~~), and whether it would like to affirm its consensus-for-exposure (as amended) on this Issue as a final consensus.

Summary of Comment Letters Received and FASB Staff Analysis

Reconsideration of the Task Force's consensus-for-exposure

2. The staff received an informal comment requesting that the Task Force reconsider the consensus-for-exposure because some believe the consensus-for-exposure produces anomalous results when the holder of an issuer's credit-enhanced liability subsequently consolidates the issuer. For example, a transferor to a securitization trust that holds a credit-enhanced retained interest (a liability of the securitization trust) may consolidate the issuer upon the adoption of FIN 46R. The anomalous result potentially arises because of the different measurement basis between the issuer's liability (which ignores the credit enhancement) and the holder's asset (which considers the credit enhancement). Consider the following example:

- A bank transfers $100 of mortgages that have not been guaranteed by a third party to an SPE. Assume the bank initially receives sale accounting under FAS 140. Further assume that the bank later concludes that it must consolidate the SPE (for example, because of the FASB's project to reconsider FAS 140 and FIN 46R).

- The SPE issues beneficial interests (BIs) of $100 to third-party investors ($90) and the bank takes back retained interests (RI) of $10 (10 percent of the total BIs). The BIs, including the RI held by the bank, have been guaranteed by a third-party guarantor.
- Assume at the date the bank consolidates the SPE that the fair value of the mortgages within the SPE is $80. Further assume that the bank carries the RIs at their guaranteed fair value of $10 (10 percent of the $100 guaranteed beneficial interests). For initial and subsequent measurements assume the consolidated entity has elected the fair value option or is otherwise required to measure the asset or liability at fair value through earnings.

3. Upon consolidation of the SPE by the bank, the application of the consensus-for-exposure would result in the following journal entries:

D.	Mortgages	$80	
D.	Guarantee asset	$2*	
C.	Payable to third-party BI holders		$72**
C.	Retained interest		$10

To write off the RI and record the assets and liabilities of the trust at fair value.

* This asset represents the ability of the bank to sell its 10 percent RI for $10 when the fair value of the underlying share of mortgages is $8 (10 percent of the un-guaranteed fair value of the mortgages of $80). If the bank were to sell its RI to third-party investors, the bank would record the following entries:

(1) D. Cash $10, C. Payable to third-party BI holders $10—To record the additional borrowing.

(2) D. Payable to third-party BI holders $2, C. Guarantee asset $2—To write-off the guarantee asset and adjust the fair value of the payable to third-party BI holders to reflect the un-guaranteed credit standing of the SPE.

**90 percent of the fair value of the SPE's obligation to third-party beneficial holders and the bank (that is, the retained interest holder) of $80 considering only the credit of the SPE per the consensus-for-exposure. In consolidation, the bank's retained interest in the SPE and the SPE's obligation to the bank are eliminated.

4. The informal commenter is concerned with the application of the consensus-for-exposure in the manner illustrated above because that commenter believes that it results in the partial consolidation ($2) of what the commenter believes is a $20 guarantee asset of the SPE. The commenter believes that the guarantee is an asset of the SPE and thus that the mortgages should be recorded at their fair value of $80 upon consolidation and that a separate $20 guarantee asset should be recorded. The journal entries upon consolidation using this alternate approach are as follows:

D.	Mortgages	$80		
D.	Guarantee asset	$20		
C.		Payable to third-party BI holders		$90*
C.		Retained interest		$10

To write off the RI and record the assets and liabilities of the trust at fair value.

*The fair value of the SPE's obligation to third-party beneficial holders considering the *guarantor's* credit standing. In consolidation, the bank's retained interest in the SPE and the SPE's obligation to the bank are eliminated.

5. The informal commenter believes that the guarantee is the asset of the SPE and therefore View C, which was presented in Issue Summary No. 1, dated June 4, 2008, is the preferred outcome in the circumstance described above and thus questions whether the consensus-for-exposure should be reconsidered. View C states,

> An issuer of debt with a third-party guarantee that is inseparable from the debt instrument should treat the debt and the guarantee as one unit of accounting. This would require that an entity include the effect of a third-party guarantee in the fair value measurement of the liability. Additionally, an issuer should record an asset upon issuance of the debt and reflect the changes in the issuer's credit rating by adjusting that asset.

6. Opponents of View C believe that the guarantee is an asset of the investors in the beneficial interests and not of the SPE. View C is premised on the notion that the issuer of the debt is the holder of the guarantee, and since the consolidation of the SPE by the transferor effectively results in the transferor being the issuer of the debt, these opponents believe that accounting for the transaction based on the consensus-for-exposure properly records the guarantee and is not a flaw in the consensus that requires reconsideration.

Question 1: Does the Task Force want to reconsider its consensus-for-exposure?

Amortized Cost Measurements

7. Some respondents and informal commenters questioned the Task Force's conclusion in paragraph 7 of the draft abstract that the "credit enhancement is obtained for the benefit of the investor and does not represent an asset of the issuer."

8. The staff believes that those concerns stem from some potential confusion about the scope of the Issue. Some may believe that the phrase "the credit enhancement is obtained for the benefit of the investor and does not represent an asset of the issuer" requires that an issuer expense the cost of the credit enhancement (for example, a third-party guarantee) at inception in circumstances outside the scope of this Issue—for example, when guaranteed debt is measured at amortized cost and the issuer has paid the entire guarantee fee upon issuance of the guaranteed debt. The staff notes that the guidance in this Issue does not apply to a liability with a third-party credit enhancement that is measured at an amount other than fair value (for example, amortized cost). Thus, this Issue does not address how the issuer accounts for the cost of the guarantee when issuing debt with a third-party guarantee that is measured at amortized cost. As noted in paragraphs 3 and 4 of Issue Summary No. 1, there may be diversity in how issuers account for the issuance of debt carried at amortized cost that has been guaranteed by a third party, but the impact on net income is generally the same (that is, the cost of the guarantee is generally amortized to expense over the life of the debt). The staff does not believe the Task Force's intent was to change existing practices for accounting for the cost of third-party guarantees outside of a fair value measurement. The staff has proposed additional language in paragraph 5 of the draft abstract to further clarify the scope of this Issue.

9. The staff has also added a sentence to the Background section in paragraph 2 of the draft abstract and removed the above referenced language in paragraphs 6 and 7 and replaced it with the following, which the staff believes better reflects the basis for the Task Force's conclusion that the issuer should not consider the effect of the third-party credit enhancement when measuring or disclosing the liability at fair value:

> **6. The issuer of a liability ~~debt~~ with a third-party credit enhancement that is inseparable from the liability ~~debt instrument~~ shall not include the effect of the credit enhancement in the fair value measurement of the liability. For example, in determining the fair value of debt with a third-party guarantee the issuer would consider its own credit standing and not that of the third-party guarantor. In addition, as noted in paragraph 3 of Statement 159, "[u]pfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred."**
>
> 7. For the issuer, t~~T~~he unit of accounting for the ~~debt~~liability measured or disclosed at fair value does not include the third-party credit enhancement (for example, a third-party guarantee of debt). ~~That credit enhancement is obtained for the benefit of the investor and does not represent an asset of the issuer.~~Any payments made by the guarantor under the guarantee result in a transfer of the issuer's debt obligation from the investor to the guarantor. The issuer's resulting debt obligation to the guarantor has not been guaranteed. Thus, the fair value of that obligation considers the issuer's credit standing and not the credit standing of the guarantor. From the perspective of the issuer, they have in-substance issued debt that has not been guaranteed.

10. The staff has also made other minor editorial changes in paragraphs 3, 4, 6, and 9 of the draft abstract.

Question 2: Does the Task Force agree with the staff's clarifying changes to the draft abstract?

Effective date

11. At its June 12, 2008 meeting, the Task Force reached a consensus-for-exposure that this Issue shall be effective on a prospective basis in the first reporting period beginning after [the date of Board ratification of the consensuses]. The effect of initially applying the guidance in this

Issue shall be included in the change in fair value in the period of adoption. Earlier application is not permitted.

12. If the Task Force affirms the consensus-for-exposure as a consensus on this Issue, the Board is scheduled to consider ratification of that consensus at its September 24, 2008 Board meeting. For a calendar year-end entity, the Issue would be effective during the quarter ending December 31, 2008.

Question 3: Does the Task Force wish to affirm the consensus-for-exposure on the effective date?

Appendix 08-5A

EITF ABSTRACTS (DRAFT)

Issue No. 08-5

Title: Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement

Dates Discussed: June 12, 2008; [September 10, 2008]

References: FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
FASB Statement No. 157, *Fair Value Measurements*
FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*

Objective

1. **The objective of this Issue is to determine an issuer's unit of accounting for debt issued with an inseparable third-party credit enhancement that is measured or disclosed at fair value.**

All paragraphs in this Issue have equal authority.
Paragraphs in bold set out the main principles.

Background

2. Debt securities are often issued with credit enhancements obtained from a ~~an unrelated~~ third~~-~~party. For example, debt may be issued with a financial guarantee from a ~~an unrelated~~ third party that guarantees the issuer's payment obligations. If the issuer fails to meet its payment obligations to the investor, the guarantor must make the payments on the issuer's behalf, and the

issuer becomes obligated to the guarantor. That guarantee is generally purchased by the issuer who then combines it with the debt and issues the combined security to an investor. By issuing debt combined with the guarantee, the issuer is able to more easily market its debt~~obtain a lower interest rate and/or receive higher initial proceeds~~.

3. Statement 159, which is effective for fiscal years beginning after November 15, 2007, allows an entity to measure its financial assets and liabilities at fair value subject to certain requirements. An entity has the option of electing the fair value option for the liability considered by this Issue. Furthermore, Statement 107 requires disclosure of the fair value of all financial instruments, with certain exceptions. Statement 157 states that the fair value of a liability shall reflect the nonperformance risk (that is, the risk that the obligation will not be fulfilled) relating to that liability. ~~As a result, q~~Questions have arisen regarding whether the issuer would consider the effect of the third-party credit enhancement when measuring the liability at fair value under Statement 157.

Scope

4. **This Issue applies to ~~debt~~ liabilities issued with an inseparable third-party credit enhancement (for example, debt that is issued with a contractual third-party guarantee) measured or disclosed at fair value.**

5. This Issue does not apply to ~~guarantees~~ credit enhancements provided by a government or government agencies; for example, deposit insurance. This Issue does not apply to liabilities issued with an inseparable third-party credit enhancement (for example, debt that is issued with a contractual third-party guarantee) that is measured or disclosed at an amount other than fair value.

Measurement

6. The issuer of a liability ~~debt~~ with a third-party credit enhancement that is inseparable from the liability ~~debt instrument~~ shall not include the effect of the credit enhancement in the fair value measurement of the liability. For example, in determining the fair value of debt with a third-party guarantee, the issuer would consider its own credit standing and not that of the third-party guarantor. In addition, as noted in paragraph 3 of Statement

159, "[u]pfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred."

7. For the issuer, t~~T~~he unit of accounting for the ~~debt~~liability measured or disclosed at fair value does not include the third-party credit enhancement (for example, a third-party guarantee of debt). ~~That credit enhancement is obtained for the benefit of the investor and does not represent an asset of the issuer.~~Any payments made by the guarantor under the guarantee result in a transfer of the issuer's debt obligation from the investor to the guarantor. The issuer's resulting debt obligation to the guarantor has not been guaranteed. Thus, the fair value of that obligation considers the issuer's credit standing and not the credit standing of the guarantor.

Disclosure

8. **An issuer shall disclose the existence of a third-party credit enhancement on its issued ~~debt~~liability in the scope of this Issue.**

Transition

9. This Issue shall be effective on a prospective basis in the first reporting period beginning after [the date of Board ratification of the consensuses]. The effect of initially applying the guidance in this Issue shall be included in the change in fair value in the ~~year~~period of adoption. Earlier application is not permitted.

10. The Task Force reached a consensus that in the period of adoption an entity shall disclose the valuation technique(s) used to measure the fair value of liabilities in the scope of this Issue and include a discussion of changes, if any, in the valuation techniques used to measure those liabilities in prior periods.

The provisions of this Issue need not be applied to immaterial items.