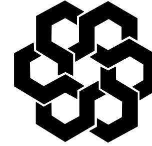

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This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**13 December 2006, London**
Project:	**Financial Instruments – Due Process Document (DPD)**
Subject:	**Recognition and Measurement (Agenda Paper 12D)**

BACKGROUND

1. At the last meeting, the Boards briefly discussed the measurement of guaranteed liabilities.

2. This paper considers how collateral affects the fair value of debt instruments to debtors and creditors, and compares that effect to liabilities with third-party contractual and statutory guarantees. This paper does not consider the effect of offset (netting) agreements which may have a similar effect to collateral in some situations.

3. The staff notes that this is a complex and (judging by the reaction to the FASB's exposure draft on Fair Value Measurement) controversial issue. This paper attempts to discuss the principal considerations, but the staff acknowledges that the Boards may be unable to take a preliminary view on some or all of these issues.

FAIR VALUE MEASUREMENT

4. Fair Value (of a liability) is defined in Statement No. 157 *Fair Value Measurement,* as the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. That Statement requires that the measurement should consider attributes specific to the liability, but that the liability could be transferred separately or as part of a group of assets and/or liabilities.

5. Paragraph 15 of that Statement also requires that the fair value of a liability should reflect the nonperformance risk relating to the liability (with nonperformance risk defined as the risk that the obligation will not be fulfilled and that affects the value at which the liability is transferred[1]). However, in measuring the fair value of a liability an entity should assume that the nonperformance risk relating to the liability is the same before and after its transfer.

6. Statement 157 is also clear that the reporting entity should consider the effect of its credit standing on the fair value of the liability, but that the effect may differ depending on the liability – for reasons including the terms of credit enhancement related to the liability (if such terms exist).

THE FOCUS OF THIS PAPER

7. This paper focuses on the accounting for the debtor. This paper does discuss issues relating to the accounting of the creditor, but only to provide additional insight into the accounting by the debtor.

HOW COLLATERAL AFFECTS THE FAIR VALUE OF DEBT INSTRUMENTS

8. Collateral increases the probability that a debtor will fulfill its obligations under a debt instrument for at least two reasons.

[1] The nonperformance risk in a financial liability is its credit risk.

9. If the debtor wants to keep the asset it pledged as collateral (for example, because that asset is instrumental to the entity's operations) then the debtor must pay its obligations under the debt instrument.

10. Therefore, such pledged collateral gives the debtor a strong incentive to pay the secured creditor instead of the unsecured creditor.

11. A second reason why collateral increases the probability that a debtor will fulfill its obligations under a debt instrument is that collateral increases a secured creditor's ability to collect the amounts due to it by threatening to foreclose or repossess, or by actually foreclosing or repossessing.

12. That is, collateral that has been legally pledged to a secured creditor allows that creditor to foreclose or repossess the collateral without necessarily forcing the debtor into bankruptcy (with all the delays and uncertainties in collection that would result).

13. These two reasons (and possibly others) hence affect the probability that the debtor will meet their obligation by making payments on time, as well as the probability that the debt will be satisfied even if the debtor does not (or cannot) perform as agreed – by foreclosure or repossession.

14. The probability of settlement and timing of the settlement are the key factors in estimating the fair value of such financial instruments as an asset and as a liability.

15. The form of the settlement (in cash or repossessed assets) is not critical in estimating the fair value, except to the extent it causes changes in timing or the amount of the cash flows. Once again, this affects both the debtor and creditor similarly.

16. In some situations, changes in the market price of the collateral may affect the estimates by both the debtor and creditor, and therefore the fair value of the debt

instrument to both. This is because the market price of the collateral[2] affects the percentage of the debt instrument that can be settled by repossession or foreclosure.

17. However, in other situations, the changes in the market price of the collateral will have little, if any, effect on either the debtor's or creditor's estimates of the timing or amount of cash (or collateral asset) flows under the debt. Such situations would include when the market price of the collateral is significantly greater than the settlement amount of the debt.

18. Therefore, collateral is seen to affect the fair value of a debt instrument both to the debtor and to the creditor.

HOW CONTRACTUAL GUARANTEES AFFECT THE FAIR VALUE OF DEBT INSTRUMENTS

19. Financial guarantees come in different forms that have potentially different effects on the fair values of financial instruments. These different forms include contractual guarantees and statutory or regulatory guarantees. This section of the paper addresses only contractual guarantees.

Should the party purchasing the guarantee affect the fair value of the debt instrument?

20. Contractual guarantees could be purchased by a number of different parties including the creditor, the debtor, the debtor (who then immediately transfers the guarantee to the creditor) or by some other third-party (such as a trust through which the debt is issued).

21. However, the identity of the party that purchases the guarantee should not affect the fair value of the debt instrument because the purchase of the guarantee is a *past* cash flow; the fair value of the debt instrument will be affected, however, by

[2] More realistically, it is the liquidation value of the collateral that affects the value of the debt; a creditor that has foreclosed or repossessed collateral assets has the right and incentive to sell that collateral quickly to realize whatever it can get – even at fire sale prices.

the way in which the guarantee might affect the timing or amount of *future* cash flows from either the debtor's or creditor's perspective.

When a guarantee affects the fair value of a debt instrument to the debtor

22. A guarantor is required to pay a creditor if the debtor does not fulfill its obligations, although the trigger point(s) for such payments by the guarantor vary.

23. Such trigger points may include the debtor being only one day past due or significantly past due. Alternatively, the creditor may have to follow certain procedures with regard to demands for payment. In some situations the debtor's financial condition may also play a role.

24. However, all of these trigger points are likely to affect the fair value of the debt instrument to the creditor, because they will affect the timing of the cash flows to the creditor.

25. This discussion has so far been with regard to how the fair value of a debt instrument to the creditor may be affected by a contractual guarantee. However, some contractual guarantees affect the fair value of a debt instrument to both the debtor and the creditor.

26. The factor that results in a contractual guarantee affecting the fair value of a debt instrument for the debtor is whether or not the debtor is released from its obligation if the guarantor is called upon to pay the creditor.

Guarantees that do not result in the release of the debtor from its obligation

27. If the debtor is not released from its obligation under the guaranteed debt even if the guarantor pays the creditor, the guarantee has no effect on the fair value of the debt instrument to the debtor.

28. However, in that case, the cash flows from the guarantor to the creditor certainly affect the fair value of the debt instrument to the creditor from the date of issuance, because the creditor is receiving payments regardless of the source of those payments.

29. In effect, a guarantee that does not result in release of the debtor from its obligation is a put option written by the guarantor and held by the creditor. That put option is exercisable only under certain conditions specified in the guarantee agreement, and the exercise price of that option is probably equal to the unpaid portion of the debt. If that option becomes exercisable, and the creditor exercises the option, the only thing that has changed from the perspective of the debtor is the identity of the creditor; that is, the guarantor has now become the creditor.

30. This situation is somewhat analogous to publicly traded bonds that are sold by one investor (creditor) to another in an open market transaction not involving the debtor. No one would expect such a bond trade to affect the fair value of the bond to the debtor. Similarly, the payment of the guarantee does not affect the fair value of the guaranteed debt to the debtor[3].

Guarantees that result in the release of the debtor from its obligation

31. If the debtor is released from its obligation under the guaranteed debt when the guarantor pays the creditor, that guarantee affects the fair value of the debt to the debtor (as well as the creditor). In effect, such a guarantee represents an asset of the debtor that might be considered somewhat analogous to insurance (for example, like mortgage life insurance under which the mortgage company pays the creditor and the debtor's heirs are released from any obligation and the lien on the property.)

32. In other words, the debtor has a right to a potential benefit under certain circumstances. If the debtor runs into financial difficulty, the guarantor has promised to step into the debtor's position and settle the debt.

33. That benefit is an asset to the debtor because it can be used to settle the debtor's liability, which is one of the potential uses of assets. The fair value of the liability

[3] In such a situation the fair value of the debt instrument *to the debtor* is probably lower than face value because the debtor is presumably experiencing financial difficulties, which will affect the probability of cash outflows (otherwise – the guarantee would not have been triggered).

to the debtor is based on the combined probability of cash flows from the debtor and cash flows from the guarantor[4].

34. Guarantees that result in the release of the debtor from their obligation are likely to be rare or nonexistent in practice because of the moral hazard involved; the debtor can take high risks without worrying about paying its debts. That circumstance existed in the 1970s and 1980s when some banks in trouble took greater risks in an attempt to recoup losses with a big gain. In that situation, it was statutory insurance that was standing behind some of the obligations of the banks (see discussion in the next section), but the incentives for a contractual guarantee that results in the release of the debtor from its obligation are the same.

Other possible considerations

Transfer of the liability between entities

35. It is worth considering a transfer of the liability between the existing debtor and another entity.

36. As noted previously, Statement 157 tells us that in measuring fair value an entity should assume that the nonperformance risk relating to the liability is the same before and after its transfer. As discussed previously, in most situations the obligation of the debtor is not affected by the existence of a contractual guarantee.

37. The transfer price for the debt instrument between the two entities would not therefore take into account the impact of the contractual guarantee (unless the contractual guarantee also provided some benefit to the debtor). In order to assume the liability another entity would require a payment equivalent to the fair value of the original debtor's obligations under the debt instrument.

Observations from a creditor's perspective

38. There are some relevant observations to make from the creditor's perspective (although, remember that we are discussing the accounting for the debtor in this

[4] If the guarantor cannot pay, then the debtor is still obligated.

paper). These include the fact that the existence of a guarantee would normally be important in the decision by the investor to lend money, and the guarantee would typically be entered into in contemplation of and contemporaneous with the issuance of the loan. The investor would make their pricing decisions based on that guarantee.

39. Furthermore, from a practical viewpoint, an investor would be unwilling to approve a transfer of a guaranteed liability from one entity to another entity of comparable credit standing unless the guarantee continued intact, which to some suggests that the guarantee forms an integral part of the liability.

Staff recommendation

40. The staff believes that a third-party contractual guarantee does not affect the fair value to the debtor of the liability related to the contractual guarantee, unless the debtor has a right to a potential benefit.

41. If the debtor does have a right to a potential benefit, the debtor should both recognize an asset as well as measuring the fair value of the liability based on the combined probability of cash flows from the debtor and cash flows from the guarantor

42. **Questions to the Boards:**

    a. **Do you want to state a preliminary view about how third-party contractual guarantees affect the fair value measurement of a liability for the debtor? If so, what is that view?**

    b. **If you believe you could answer those questions is some additional information were provided, what additional information do you need?**

STATUTORY (OR REGULATORY) FINANCIAL GUARANTEES

43. Another form of a guarantee for certain liabilities is that provided by a government or government agency. Such guarantees commonly exist in regulated financial service markets for retail investors.

44. The question of how to treat such a guaranteed liability is also related to an issue discussed in the first series of DPD papers - the possible interaction between the law and the rights and obligations that form a contract.

45. An example is deposit insurance. That insurance is provided by a government or government agency and covers all liabilities that have specific characteristics (typically retail deposits up to a certain size). The deposit taking entities are, in exchange for this guarantee, subject to specific regulatory oversight. Typically, if such guaranteed liabilities are to be transferred, they may only be transferred to another entity whose deposits are also covered by the insurance scheme.

46. Unlike the financial guarantees discussed previously, deposit insurance is statutory in nature. It is therefore not a financial instrument because it is not a contract or an ownership interest.

47. In addition, rather than simply paying out the guarantee if the deposit taking entity fails, the guarantor typically takes over the deposit-taking entity (or arranges a take-over of the deposit-taking entity or assumption of the guaranteed liabilities), hence ensuring that the insured liabilities are partially or wholly satisfied by the entity itself. This suggests that any value in such statutory insurance schemes actually arises from the regulators' ability (and propensity) to intervene, rather than deriving from the guarantee mechanism itself.

48. Some evidence suggests that in some jurisdictions interest rates on uninsured and insured deposits do not significantly vary (although, in other jurisdictions, certificate of deposits that are larger than the deposit limit are priced differently

than guaranteed certificates; whether this is related to the sheer size of the certificates, or the effect of deposit insurance is difficult to discern however).

49. A similar approach to that used in the previous discussion on contractual guarantees suggests that statutory and similar guarantees do provide future benefit to the debtor; under a statutory guarantee the debtor is released from its obligation because the guarantor has stepped into the debtor's position and repaid the debt (or, as discussed above, has more likely arranged for the liabilities to be transferred and 'run-off').

50. Such an analysis suggests that such a benefit is an asset to the debtor because it can be used to settle the debtor's liability – and hence that the fair value of the liability should be also take into account the effect of the guarantee.

51. In many circumstances, the value of such deposit insurance may negligible (whether it arises directly from the guarantee mechanism or indirectly from the ability of the regulator to intervene), given that there is a low probability that regulated entities covered by a deposit insurance scheme will default.

52. This might suggest that the Boards, for statutory and similar financial guarantees, should not require separate reporting but that the effect, to the extent it exists, should be included in the valuation of the insured deposits.

53. However, as in the discussion previously on contractual financial guarantees (and assuming that the deposit insurance actually has some value), this would still leave the question of whether the bank or other regulated entity should also recognize some type of (non-financial asset) for the deposit insurance guarantee.

Staff recommendation

54. The staff believes that the effect of statutory deposit and similar guarantees (whether it arises directly from the guarantee or indirectly through the ability and propensity of the regulator to intervene) should be included in the valuation of the insured deposits or other liabilities.

55. **Questions to the Boards:**

a. **Do you want to state a preliminary view about how the fair value of liabilities with statutory and similar guarantees from the debtor's perspective should be measured? If so, what is that view?**

b. **If the Boards believe that the fair value of such liabilities from the debtor's perspective should incorporate the effect of statutory and similar guarantees, then should the borrower recognize a separate asset? If so, what is that asset and how should it be accounted for subsequent to recognition?**

c. **If you believe you could answer those questions if some additional information were provided, what additional information do you need?**