

**Statement 133 Implementation Issues  
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Posted on May 6, 2002**

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Revised 05/06/02

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Revised 05/06/02

**Title:** Definition of a Derivative: Application of Paragraph 6(b) regarding Initial Net Investment  
**Paragraph references:** 6, 8, 9, 12–16  
**Date released:** October 2001

**Revised May 6, 2002**

**Note:** The guidance in this Issue is tentative and may be finalized if an amendment to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is issued. The Board issued the Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, on May 1, 2002.

## QUESTION

How should paragraph 6(b) be applied for contracts that involve elements of a financing?

## BACKGROUND

The Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, proposes that paragraph 6(b) of Statement 133 be replaced by the following:

- b. If it is an option-based contract,<sup>\*</sup> it has an initial net investment equal to the fair value of the option component. If it is not an option-based contract (hereafter referred to as a non-option-based contract), it requires an initial net investment that is less than 5 percent of the fully prepaid amount.<sup>†</sup>

<sup>\*</sup>An option-based contract is a contract that either is a freestanding option or has an embedded option. A contract that contains an embedded option for which the strike price is fair value at the time of exercise should be considered non-option-based for purposes of applying this paragraph.

<sup>†</sup>For non-option-based contracts, judgment of whether an initial net investment is less than 5 percent of the fully prepaid amount should be made based on comparison of the initial net investment to the amount of investment that would result in the contract becoming fully prepaid. Non-option-based contracts are fully prepaid if one party invests the fair value of all its future cash outflows under the contract and no longer has to sacrifice additional assets to settle the contract.

Paragraph 12 of Statement 133 states, in part:

An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract....

- b. The contract (“the hybrid instrument”) that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

The Exposure Draft proposes adding the following language to paragraph 12:

A contract that, in its entirety, meets the definition of a derivative but is a non-option-based contract that requires an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in paragraph 6(b)) may be accounted for as either (1) a derivative in its entirety or (2) a hybrid instrument that must be bifurcated into a debt host and a derivative with a fair value of zero at acquisition of the hybrid instrument.

This issue addresses the application of that proposed guidance to three example structures.

#### **Example 1—Prepaid Interest Rate Swap Contract**

Company A pays \$1,228,179 to enter into a prepaid interest rate swap contract that requires the counterparty to make quarterly payments based on a \$10,000,000 notional amount and an annual interest rate equal to 3-month US\$ LIBOR. Company A pays the present value of the fixed leg of the swap at the inception of the contract. (Alternatively, Company A could have entered into a plain-vanilla 2-year pay-fixed, receive-variable swap with a \$10,000,000 notional amount, a fixed interest rate of 6.65 percent, and a variable interest rate of 3-month US\$ LIBOR.) The amount of \$1,228,179 is the present value of the 8 quarterly fixed payments of \$166,250, based on the implied spot rate for each of the 8 payment dates under the assumed initial yield curve in that example.

#### **Example 2—Structured Note**

Company B pays \$1,228,179 to enter into a structured note with a principal amount of \$1,228,179 and loan payments based on a formula equal to 8.142 times 3-month US\$ LIBOR. (Note that  $8.142 = 10,000,000 / 1,228,179$ .) The terms of the structured note specify no repayment of the principal amount either over the two-year term of the structured note or at the end of its term.

#### **Example 3—Interest Rate Swap with Floating Rate Capped**

Company C enters into a two-year interest rate swap that receives floating-rate cash flows based on LIBOR and pays fixed-rate cash flows. The swap has a \$10,000,000 notional amount, a fixed rate of 6.64 percent, and a variable interest rate of 3-month LIBOR. The floating rate of the swap is capped at 6 percent. That is, if LIBOR exceeds the 6 percent threshold, the floating leg

is calculated using the 6 percent rather than the current higher rate. The writer of the cap (the entity receiving LIBOR) receives no premium at the inception of the swap. Rather the premium of \$18,838 is received over the life of the swap on a pro rata basis as part of each payment under the swap. The fixed rate on the swap has been adjusted from 6.65 percent to 6.64 percent so that the fair value of the swap is zero at inception. As a result, the swap component has terms that are off-market.

All three examples meet the characteristic of a derivative in paragraph 6(a), because they have underlyings and notional amounts. In Example 2, the true notional amount for the contract is the stated notional amount times the leverage factor. All three examples also meet the characteristic of a derivative in paragraph 6(c) because neither party is required to deliver an asset that is associated with the underlying or that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (refer to paragraph 9(a)). In Example 2, although the investor may deliver the structured note to the issuer at maturity, the stated amount of the note (\$1,228,179) is not equal to the actual notional amount (\$10,000,000).

## **RESPONSE**

As discussed in the Background section, for contracts that are non-option-based, the characteristic in paragraph 6(b) of Statement 133 is satisfied only if the initial investment in the contract is less than 5 percent of the amount required to fully prepay the contract. Option-based contracts (that is, freestanding options or instruments with embedded options) that involve an initial net investment equal to the fair value of the option component satisfy the characteristic in paragraph 6(b). Depending on the specific terms of the contract, the fair value of the option component may incorporate time and intrinsic value.

Contracts that do not meet the definition of a derivative in paragraph 6 of Statement 133 are considered hybrid instruments that must be evaluated under paragraphs 12–16 of Statement 133 to determine whether bifurcation of an embedded derivative is required. If a non-option-based contract has an initial net investment that is less than 5 percent of the fully prepaid amount and the characteristics in paragraphs 6(a) and 6(c) are also met, an entity is permitted to account for the contract as either a derivative in its entirety or a hybrid instrument that must be bifurcated into a debt host and a derivative whose fair value is zero at acquisition of the hybrid instrument.

The analysis of the three examples in the Background section is below.

### **Examples 1 and 2**

The prepaid interest rate swap discussed in Example 1 and the structured note discussed in Example 2 do not meet the characteristic of a derivative in paragraph 6(b). Both contracts are non-option-based contracts that require an initial investment of \$1,228,179, which is the amount that results in the contracts becoming fully prepaid. Therefore, both contracts should be evaluated under paragraph 12 of Statement 133. The contracts should be bifurcated into a debt host contract and an interest rate swap whose fair value is zero at inception of the hybrid

instrument, in accordance with Statement 133 Implementation Issue No. B20, “Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?”

In both Examples 1 and 2, bifurcation of an embedded interest rate swap is required because LIBOR may decrease to such a level that the investor may not recover its initial net investment of \$1,228,179. Therefore, the embedded interest rate swap is not considered clearly and closely related to the host contract under paragraph 13(a) of Statement 133. Paragraph 61(a), which further explains paragraph 13(a), states that if an embedded interest rate derivative contains a provision that permits any possibility whatsoever that the investor’s (or creditor’s) undiscounted net cash inflows over the life of the instrument would not enable the investor to recover substantially all of its initial recorded investment in the hybrid instrument under its contractual terms, the contract must be bifurcated.

If the structured note in Example 2 is a debt security within the scope of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and is classified by the holder as a trading security, the contract would not require bifurcation in accordance with paragraph 12(b) of Statement 133.

### **Example 3**

The interest rate swap with the floating rate cap discussed in Example 3 does not meet the characteristic of a derivative in paragraph 6(b). The contract has an embedded option and therefore should be evaluated as an option-based instrument under paragraph 6(b). The contract does not meet the characteristic of a derivative in paragraph 6(b) because the initial net investment is zero, rather than the fair value of the option component (\$18,838). Therefore, this structure should be evaluated under paragraph 12 and should be bifurcated into a debt host (with a value equal to the option premium of \$18,838) and a compound derivative comprised of an at-the-money swap component and a written cap component. In the case of an option-based embedded derivative, in accordance with Statement 133 Implementation Issue No. B22, “Whether the Terms of a Separated Option-Based Embedded Derivative Must Produce a Zero Fair Value (Other than Time Value),” the terms of the option-based embedded derivative should not be adjusted to result in the derivative’s being at-the-money at the inception of the hybrid.

### **Effective Date and Transition**

The effective date of the revised implementation guidance in this Issue is the first day of the first fiscal quarter beginning after November 15, 2002. If an entity had been accounting for a contract as a derivative under Statement 133 Implementation Issue No. A9, “Prepaid Interest Rate Swaps,” the entity should continue to account for the contract as a derivative. The accounting for existing instruments as derivatives should not be changed. Entities should apply the revised guidance prospectively for future transactions.

*The above response represents a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB and incorporated in an FASB staff implementation guide, which is contingent upon an amendment of Statement 133 being issued. Constituents should send their comments, if any, to Suzanne Bielstein, Director of Major Projects and Technical Activities, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116 (or by e-mail to [derivatives@fasb.org](mailto:derivatives@fasb.org)) by July 1, 2002.*

**Title:** Embedded Derivatives: Beneficial Interests Issued by Qualifying Special-Purpose Entities  
**Paragraph references:** 12, 60, 61  
**Date released:** October 1999

**Revised May 6, 2002**

**Note:** The guidance in this Issue is tentative and may be finalized if an amendment to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is issued. The Board issued the Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, on May 1, 2002.

## QUESTION

How should a beneficial interest issued by a qualifying special-purpose entity (SPE), as defined by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, be evaluated under paragraph 12 of Statement 133?

## BACKGROUND

Paragraph 12 of Statement 133 requires that an embedded derivative be accounted for separately as a freestanding derivative instrument if all of the following criteria are met: (a) the economic characteristics of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract, (b) the hybrid instrument is not remeasured at fair value with changes in fair value reported in earnings as they occur, and (c) a separate instrument with the same terms as the embedded derivative instrument would meet the definition of a derivative instrument subject to the requirements of Statement 133.

As discussed in Statement 133 Implementation Issue No. D2, “Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1),” a beneficial interest issued in a securitization transaction that does not meet the definition of a derivative in its entirety must be evaluated under paragraph 12 similar to any other security that may contain terms that affect some or all of the cash flows required by the contract in a manner similar to a derivative instrument. In discussing the application of paragraph 12, Implementation Issue D2 states:

In evaluating whether a beneficial interest that does not meet the definition of a derivative has an embedded derivative requiring bifurcation under paragraph 12, a beneficial interest holder must consider the terms of the beneficial interest itself and the aggregate sources of cash flows that are available to service the interest. That is, beneficial interest holders must consider whether the nature and extent of cash flows generated by the securitized financial instruments are or are not consistent with the stated terms of the interest. Further, the consideration of

whether a beneficial interest contains an embedded derivative that must be bifurcated should include the priority of interests (that is, the “cash waterfall”), the relative concentration of risks across various tranches of securities issued by the securitization vehicle, and the nature of any additional credit enhancement or other guarantee available to the interests.

Paragraphs 60 and 61 provide additional guidance for determining when a hybrid instrument contains an embedded derivative that is not clearly and closely related to the host contract.

Questions have been raised regarding the application of the bifurcation guidance in Statement 133 to beneficial interests issued by qualifying SPEs. Specifically, some have questioned whether an investor’s beneficial interest in a qualifying SPE is automatically a hybrid instrument that contains an embedded derivative requiring bifurcation if the qualifying SPE holds a combination of debt or equity securities and derivative instruments. In addition, some have questioned how to determine the nature of the host contract in performing the bifurcation analysis.

Four examples of securitization transactions involving qualifying SPEs are outlined below.

**Example 1**

A qualifying SPE holds fixed-rate corporate bonds (7 percent coupon rate) and a pay-fixed (at 7 percent), receive-variable (LIBOR) interest rate swap. The notional amount of the swap matches the principal amount of the corporate bonds, and the expiration date of the swap matches the maturity date of the bonds. An investor purchases a beneficial interest issued by the qualifying SPE that has an interest rate based on LIBOR and a maturity date that is the same as the securitized instruments.

**Example 2**

A qualifying SPE holds EURO-denominated variable-rate corporate bonds and a pay-floating-EURO and receive-fixed-U.S. dollar foreign currency interest rate swap. The notional amount of the swap matches the principal amount of the corporate bonds, and the index on which the swap’s variable rate is based matches the index on which the bonds’ variable rate is based. Also, the swap’s repricing dates match the repricing dates of the bonds, and the expiration date of the swap matches the final maturity date of the bonds. An investor purchases a beneficial interest issued by the qualifying SPE that is denominated in U.S. dollars and has a fixed interest rate. The beneficial interest has a maturity date that is the same as the securitized instruments.

**Example 3**

A qualifying SPE holds 1000 shares of common stock of Company ABC. An investor purchases a beneficial interest issued by the qualifying SPE in the form of private-company equity. The investor receives all distributions and dividends related to the shares of Company ABC common stock held by the qualifying SPE. However, the investor does not have voting rights typical of a

Company ABC shareholder. For the purposes of this example, assume that the investment in Company ABC common stock is a passive investment that meets the requirements discussed in paragraph 39 of Statement 140.

**Example 4**

A qualifying SPE holds 1000 shares of common stock of Company XYZ. An investor purchases a senior beneficial interest issued by the qualifying SPE that has a fixed interest rate. The transferor holds a beneficial interest in the form of private-company equity, which absorbs the first losses related to the securitized shares of common stock. There is no third-party guarantee provided for the senior interest. For the purposes of this example, assume that the investment in Company XYZ common stock is a passive investment that meets the requirements discussed in paragraph 39 of Statement 140.

For purposes of the above examples, assume that the investor does not consolidate the qualifying SPE.

**RESPONSE**

For the purposes of applying the guidance in paragraphs 12, 60 and 61 of Statement 133, all beneficial interests issued by qualifying SPEs (as defined by Statement 140) that contain embedded derivative features should be considered hybrid instruments with debt host contracts. Accordingly, if a beneficial interest in a qualifying SPE incorporates a return that is based on a risk type other than interest rates (such as an equity-based return), the embedded derivative that incorporates the equity-based return would not be clearly and closely related to the host contract and would require bifurcation. In addition, if a beneficial interest in a qualifying SPE incorporates a return based on interest rates, but the beneficial interest can be contractually settled in such a way that the investor would not recover substantially all of its initial recorded investment due to an embedded interest rate feature, the embedded derivative would not be considered clearly and closely related to the debt host contract and would require bifurcation.

A beneficial interest issued by a qualifying SPE should not automatically be considered a hybrid instrument that contains an embedded derivative requiring bifurcation simply because the qualifying SPE holds a combination of instruments—that is, debt and equity securities and derivative instruments. As discussed in Implementation Issue D2, in evaluating whether a beneficial interest has an embedded derivative requiring bifurcation under paragraph 12, a beneficial interest holder must consider both the terms of the beneficial interest it holds and the aggregate sources of cash flows that are available to service the interest.

The examples in the Background section are analyzed as follows.

**Example 1**

The investor holds a beneficial interest with a payoff equal to a variable-rate bond based on LIBOR. The beneficial interest does not incorporate a return that is based on a risk

type other than interest rates. The securitized instruments—the fixed rate bonds with a 7 percent coupon rate and the interest rate swap with fixed payments based on a 7 percent rate and a floating leg based on LIBOR—provide sufficient LIBOR cash flows to satisfy the terms of the beneficial interest. Therefore, the beneficial interest does not contain an embedded derivative that warrants separate accounting under Statement 133.

**Example 2**

The investor holds a beneficial interest with a payoff equal to a U.S.-dollar denominated fixed-rate bond. The beneficial interest does not incorporate a return that is based on a risk type other than interest rates. The securitized instruments—the EURO-denominated variable-rate corporate bonds and the receive-fixed-U.S. dollar foreign currency interest rate swap—provide sufficient U.S. dollar fixed-rate cash flows to satisfy the terms of the beneficial interest. Therefore, the beneficial interest does not contain an embedded derivative that warrants separate accounting under Statement 133.

**Example 3**

The investor holds a beneficial interest with a return based on Company ABC common stock. The beneficial interest must be analyzed as a debt host contract. Because the beneficial interest incorporates a return based on equity prices, it contains an embedded feature based on equity prices. That embedded feature permits the investor to participate in fair value changes of Company ABC common stock and incorporates a floor on equity prices that effectively limits the potential loss that would result from a decline in value of Company ABC stock. The embedded equity derivative is not clearly and closely related to the host contract and would require bifurcation.

**Example 4**

The investor in the senior interest holds a beneficial interest with stated terms that provide for a fixed return. The transferor holds an interest with an equity-based return. Both beneficial interests must be analyzed as debt host contracts. The transferor's interest contains an embedded feature that permits the investor to participate in fair value changes of Company XYZ common stock, after the senior interest is satisfied, plus a purchased floor on equity prices (when the transferor's interest has a fair value of zero) that effectively limits the potential loss that would result from a decline in value of Company XYZ stock. The embedded equity derivative is not clearly and closely related to the host contract and would require bifurcation. With respect to the investor's senior interest, although the stated terms of the interest indicate a fixed return, the securitized shares of Company XYZ stock may not provide sufficient cash flows to satisfy the stated terms of the interest. Therefore, the investor's interest contains an embedded feature that is a written cap on equity prices equal to the investor's stated fixed return plus a purchased floor on equity prices that effectively limits the potential loss that would result from a decline in value of Company XYZ stock to the amount beyond the loss absorbed by the junior interest. Therefore, the senior interest contains an embedded equity derivative that is not clearly and closely related to the host contract and would require bifurcation.

If a beneficial interest in a qualifying SPE is not a derivative in its entirety and does not contain an embedded derivative that warrants separate accounting under Statement 133, the investor should consider the applicability of paragraphs 14 and 362 of Statement 140, which require that retained interests in securitizations in which the holder may not recover substantially all of its recorded investment be subsequently measured like investments in debt securities classified as available-for-sale or trading under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

**Effective Date and Transition**

The effective date of the revised implementation guidance in this Issue is the first day of the first fiscal quarter beginning after November 15, 2002. If an entity had not bifurcated an embedded derivative but is required to do so under the revised guidance, the entity should account for the effects of initially complying with the revised implementation guidance prospectively for all existing beneficial interests whether purchased in a third-party securitization or retained by transferors as of the effective date of this Issue, except for the existing contracts that qualify for the grandfathering provisions of paragraph 50, which exempts certain hybrid instruments from the embedded derivative provisions of Statement 133 on an all-or-none basis. The effects of initially complying with the revised implementation guidance as of the effective date should be reported as a cumulative-effect-type adjustment of net income.

*The above response represents a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB and incorporated in an FASB staff implementation guide, which is contingent upon an amendment of Statement 133 being issued. Constituents should send their comments, if any, to Suzanne Bielstein, Director of Major Projects and Technical Activities, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116 (or by e-mail to [derivatives@fasb.org](mailto:derivatives@fasb.org)) by July 1, 2002.*

**Title:** Embedded Derivatives: Bifurcation of Embedded Credit Derivatives  
**Paragraph references:** 12, 61(c)  
**Date released:** May 2002

**Note:** The guidance in this Issue is tentative and may be finalized if an amendment to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is issued. The Board issued the Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, on May 1, 2002.

## QUESTION

In what instances does Statement 133 require bifurcation of an instrument into a debt host contract and an embedded credit derivative?

## BACKGROUND

Paragraph 61(c) of Statement 133 discusses whether certain embedded credit derivatives are clearly and closely related to the host contract. It states:

*Credit-sensitive payments.* The creditworthiness of the debtor and the interest rate on a debt instrument are considered to be clearly and closely related. Thus, for debt instruments that have the interest rate reset in the event of (1) default (such as violation of a credit-risk-related covenant), (2) a change in the debtor's published credit rating, or (3) a change in the debtor's creditworthiness indicated by a change in its spread over Treasury bonds, the related embedded derivative would *not* be separated from the host contract.

The following three examples illustrate instruments that have different types of credit-related risk.

### Example 1—Credit-Linked Note Issued by a Corporation

Company A issues a fixed-rate, 10-year, \$10 million credit-linked note to an investor that provides for periodic interest payments and the repayment of principal at maturity. However, upon default of a specified reference security (a Company X subordinated debt obligation)<sup>1</sup> the

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<sup>1</sup> Generally, the term *reference security* refers to the security whose credit rating or default determines the cash flows under a credit derivative. Usually the terms of a credit-linked note explicitly reference a CUSIP number of a security in the marketplace.

redemption value of the note may be zero or there may be some claim to the recovery value of the reference security (depending on the terms of the specific arrangement). In an event of default of the specified reference security, there is no recourse to the general credit of the issuer (Company A). In exchange for accepting the default risk of the reference security, the note entitles the investor to an enhanced yield. The transaction results in the investor “selling credit protection” and Company A “buying credit protection.”

### **Example 2—Synthetic Credit Structure**

Company B creates an SPE and transfers 10-year U.S. Treasury securities into the SPE. Company B also enters into a 10-year, \$10 million credit default swap<sup>2</sup> with the SPE. The SPE issues \$10 million of 10-year credit-linked notes to investors (the proceeds of which are used to buy the Treasury securities). The fixed rate on the notes provide an enhanced yield for assuming the default risk of the reference security (a Company Y subordinated debt obligation). Assume that the following will occur in an event of default of the reference security: Company B receives a payment from the SPE under the terms of the credit derivative (the source of the payment is the liquidation of Treasuries) and the investor’s note has a redemption value of zero (based on the redemption provisions of the note). For the purposes of this example, the Treasuries and the credit default swap are the only assets of the SPE. The transaction results in the investor “selling credit protection” and Company B “buying credit protection.”

### **Example 3—Securitization of Corporate Bonds**

Company C creates an SPE and transfers \$10 million of 10-year, fixed-rate Company Z subordinated debt securities into the SPE. The SPE issues \$10 million of 10-year, fixed-rate beneficial interests to investors. Assume the interests are *pari passu* (that is, they have an equal participation in the cash flows from the underlying assets) and there is no credit enhancement in the structure. In an event of default of the Company Z debt securities, the transaction unwinds, the securities are sold in the marketplace, and the proceeds are distributed to investors.

## **RESPONSE**

Paragraph 61(c) of Statement 133 indicates that the creditworthiness of an issuer of a debt instrument and the interest rate on that instrument are clearly and closely related. Paragraph 190 illustrates a credit sensitive bond in which the interest rate resets based on changes in the issuer’s credit rating. The analysis of that example indicates that bifurcation of an embedded credit derivative is not required. Conversely, if an instrument incorporates a credit risk exposure that is different from the risk exposure arising from the creditworthiness of the issuer of that instrument,

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<sup>2</sup>Credit default swaps are bilateral contracts in which one party pays a fee (up front or over time) and the other party agrees to make payments that are contingent upon the default of one or more third-party reference credits. Those payments are designed to replicate the actual loss (relative to the par value of the reference credit) experienced by creditors of the third-party reference credits in an event of default. The term *default* is defined under the contract, but it is usually defined as bankruptcy, insolvency, or failure to meet payment obligations when due.

such that the value of the instrument is affected by an event of default or a change in creditworthiness of an entity that is not the issuing entity, bifurcation of an embedded derivative is required.

The credit-linked note described in Example 1 includes an embedded credit derivative that must be bifurcated. In that example, the credit risk exposure of the reference security (Company X) and the risk exposure arising from the creditworthiness of the issuer (Company A) are not clearly and closely related.

Consistent with the results in Example 1, the credit-linked note issued by the SPE described in Example 2 should be bifurcated into a debt host contract and an embedded credit derivative. The value of the credit-linked notes issued in Example 2 is directly responsive to a credit event that is related to assets that are external to the securitization vehicle.

In contrast, in the securitization transaction described in Example 3, there is no embedded credit derivative to be bifurcated because the credit risk of the actual securitized assets is passed directly to the beneficial interest holders. Statement 133 Implementation Issue No. D2, “Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1),” directly addresses that scenario. It states, “...if either prepayment or credit risks are embedded in a subordinated beneficial interest and those risks *relate only to the securitized assets*, then those implicit prepayment or credit derivatives should not be bifurcated from the host contract” (emphasis added).

### Effective Date and Transition

The effective date of the implementation guidance in this Issue is the first day of the first fiscal quarter beginning after November 15, 2002. If an entity had not bifurcated an embedded derivative but is required to do so under the revised guidance, the entity should account for the effects of initially complying with the revised implementation guidance prospectively for all existing beneficial interests whether purchased in a third-party securitization or retained by transferors as of the effective date of this Issue, except for the existing contracts that qualify for the grandfathering provisions of paragraph 50, which exempts certain hybrid instruments from the embedded derivative provisions of Statement 133 on an all-or-none basis. The effects of initially complying with the revised implementation guidance as of the effective date should be reported as a cumulative-effect-type adjustment of net income.

*The above response represents a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB and incorporated in an FASB staff implementation guide, which is contingent upon an amendment of Statement 133 being issued. Constituents should send their comments, if any, to Suzanne Bielstein, Director of Major Projects and Technical Activities, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116 (or by e-mail to [derivatives@fasb.org](mailto:derivatives@fasb.org)) by July 1, 2002.*

**Title:** Scope Exceptions: Application of the Exception in Paragraph 14 to Beneficial Interests that Arise in a Securitization  
**Paragraph references:** 14  
**Date released:** October 2001

**Revised May 6, 2002**

**Note:** The guidance in this Issue is tentative and may be finalized if an amendment to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is issued. The Board issued the Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, on May 1, 2002.

## QUESTION

What types of beneficial interests arising from securitization<sup>1</sup> transactions qualify for the exception in paragraph 14 of Statement 133?

## BACKGROUND

Paragraph 14 of Statement 133 states:

...interest-only strips and principal-only strips are not subject to the requirements of this Statement provided they (a) initially resulted from separating the rights to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative that otherwise would have been accounted for separately as a derivative pursuant to the provisions of paragraphs 12 and 13 and (b) *do not incorporate any terms not present in the original financial instrument* described above. [Emphasis added.]

The following three examples illustrate securitization transactions in which beneficial interests are issued that may or may not qualify for the paragraph 14 exception.

### Example 1

Company A transfers agency mortgage-backed securities (MBS) to a qualifying SPE in a transfer that meets the requirements for sale accounting under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Certain payments on the MBS are guaranteed, and have the implicit backing of the Federal government and, therefore, the MBS bear negligible credit risk. The beneficial interests are a principal-only strip and an interest-only strip. Principal-only investors have essentially purchased zero-coupon

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<sup>1</sup> Statement 140 defines a *securitization* as “the process by which financial assets are transformed into securities.” The term *securities* is defined in paragraph 137 of Statement 115.

debt of uncertain maturity, and the interest-only holders have the right to a series of “interest” payments that are subject to prepayment risk because the MBS will prepay when the mortgages prepay.

### **Example 2**

Company B transfers a pool of fixed-rate prepayable loans into a qualifying SPE in a transfer that meets the requirements for sale accounting under Statement 140. The A class, which has a principal amount of \$567 million, is the senior class and will only experience losses related to prepayment or credit risk if the subordinate classes (M1, M2, B1, and B2) lose 100 percent of their investment. The total investment for the subordinated classes is \$133 million. The classes with the lower credit ratings support the more senior classes, *and* prepayments are allocated to the most senior class only after prepayments are allocated to the junior interests first. In no case do investors in any class of beneficial interests need to cover losses in excess of their investment. All beneficial interests meet the definition of *security* in Statement 115. The interest rate is fixed for beneficial interests issued in all tranches.

### **Example 3**

Company C transfers a pool of fixed-rate prepayable loans into a qualifying SPE in a transfer that meets the requirements for sale accounting under Statement 140. The senior interest (A-class—equal to roughly 80 percent of the receivables’ fair value) receives interest at a variable rate indexed to LIBOR. The subordinated class (B-class) receives any residual cash flow; however, the B-class investors are never required to reimburse the A-class investors (that is, the A-class investors can never receive more than 100 percent of the cash flows from the loans transferred into the qualifying SPE).

## **RESPONSE**

Any beneficial interest issued in a securitization transaction that meets the criteria in paragraph 14 of Statement 133 qualifies for the scope exception provided in that paragraph. That is, that scope exception is not limited only to interest-only strips and principal-only strips issued in securitization transactions. In order to determine whether a beneficial interest qualifies for the exception provided in paragraph 14, a beneficial interest holder should consider the particular assets in the securitization that are the source of cash flows for the beneficial interest to determine whether the two criteria in paragraph 14 are satisfied, as discussed in the paragraphs below.

The criterion in paragraph 14(a) is satisfied if (1) the cash flows associated with the beneficial interests result from initially separating the rights to receive the contractual cash flows of securitized financial instruments, (2) the securitized financial instruments do not themselves contain any embedded derivatives that would under the requirements of paragraph 12 require separate accounting, and (3) the securitized pool does not contain any freestanding derivatives that were entered into or transferred to the qualifying SPE. Accordingly, paragraph 14(a) would not be satisfied for a securitization of equity securities, which by their nature do not have

contractual cash flows. Similarly, the criterion in paragraph 14(a) would not be satisfied for a securitization involving the distribution of liquidation proceeds upon termination of an SPE prior to the maturity of the securitized assets. Such a termination is based on the legal documents establishing the SPE, and the distribution of liquidation proceeds is not considered a contractual cash flow as described in paragraph 14(a). However, early termination triggered by a call or prepayment feature associated with a securitized asset, which is a contractual cash flow related to the asset itself, does not preclude a beneficial interest from qualifying for the paragraph 14 scope exception.

In accordance with paragraph 14(a), beneficial interests issued in a securitization would not be eligible for the scope exception if the cash flows received by beneficial interest holders related to the combination of cash flows from certain securitized assets and derivative(s) entered into at the time of securitization or later. For example, if an interest rate swap that converts fixed-rate cash flows to floating-rate cash flows was entered into at the time of securitization of fixed-rate loans or later, and the beneficial interest holders received floating-rate cash flows, the resultant beneficial interests would not be eligible for the scope exception.

The criterion in paragraph 14(b) is satisfied if the beneficial interests in the securitized assets receive cash flows that arise solely from the *particular* assets that were securitized. That is, the criterion in paragraph 14(b) is satisfied only if the cash flows arising from those securitized assets simply “pass-through” to the beneficial interests holders without changing the basic nature of those cash flows. Beneficial interests that reflect only the prepayment or credit risk of the particular securitized assets qualify for the scope exception, *even if* those risks are not proportionally allocated among tranches. However, the criterion in paragraph 14(b) would not be satisfied if the cash flows attributed to the beneficial interests could be adjusted based on the credit risk of assets other than the transferred financial assets or based on an external index such as the S&P 500, because those cash flows originate from a source other than the particular securitized assets.

Beneficial interests that meet the criteria in paragraph 14 are not subject to Statement 133. Those interests should not be further evaluated to determine whether they meet the definition of a derivative in paragraph 6 of Statement 133 or whether they contain any embedded derivatives that would otherwise require bifurcation.

An analysis of the examples in the Background section is presented below.

### **Example 1**

The beneficial interests qualify for the scope exception in paragraph 14 because they receive cash flows arising from only the particular assets being securitized (the MBS) and are exposed only to the prepayment risk of those assets.

**Example 2**

The beneficial interests also qualify for the paragraph 14 scope exception because there is only prepayment and credit risk present, and both risks pertain directly to the particular assets being securitized.

**Example 3**

The A-class beneficial interest holders receive cash flows that are indexed to LIBOR. Because LIBOR-based cash flows do not arise from the particular securitized assets, which are fixed-rate loans, the A-class is not eligible for the paragraph 14 scope exception. The B-class beneficial interest holders absorb the prepayment risk of the particular securitized loans. While that in and of itself does not disqualify the B-class from the paragraph 14 scope exception, its residual return as determined by the difference between the fixed-rate cash flows of the securitized assets and the LIBOR-based cash flows received by the A-class beneficial interest holders are not the direct fixed-rate cash flows of the particular assets that were securitized. As such, the B-class is also not eligible for the paragraph 14 exception.

**Effective Date and Transition**

The effective date of the revised implementation guidance in this Issue is the first day of the first fiscal quarter beginning after November 15, 2002. If an entity had not accounted for a beneficial interest as a derivative in its entirety or had not bifurcated an embedded derivative but is required to do so under the revised guidance, the entity should account for the effects of initially complying with the revised implementation guidance prospectively for all existing beneficial interests whether purchased in a third-party securitization or retained by transferors as of the effective date of this Issue, except for the existing contracts that qualify for the grandfathering provisions of paragraph 50, which exempts certain hybrid instruments from the embedded derivative provisions of Statement 133 on an all-or-none basis. The effects of initially complying with the revised implementation guidance as of the effective date should be reported as a cumulative-effect-type adjustment of net income.

*The above response represents a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB and incorporated in an FASB staff implementation guide, which is contingent upon an amendment of Statement 133 being issued. Constituents should send their comments, if any, to Suzanne Bielstein,, Director of Major Projects and Technical Activities, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116 (or by e-mail to [derivatives@fasb.org](mailto:derivatives@fasb.org)) by July1, 2002.*

**Title:** Recognition and Measurement of Derivatives: Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1)

**Paragraph references:** 6, 12–16

**Date released:** October 2001

**Revised May 6, 2002**

**Note:** The guidance in this Issue is tentative and may be finalized if an amendment to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is issued. The Board issued the Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, on May 1, 2002.

## QUESTION

How should beneficial interests issued in securitization transactions subject to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, be accounted for under Statement 133?

## BACKGROUND

In June 2000, the FASB cleared interim staff guidance in Statement 133 Implementation Issue No. D1, “Application of Statement 133 to Beneficial Interests in Securitized Financial Assets.” That Issue included the following implementation questions regarding the application of Statement 133 to certain beneficial interests issued in securitization transactions:

1. What types of instruments qualify for the exception in paragraph 14 of Statement 133? Does that exception apply to only certain interest-only and principal-only strips or does it apply to other types of beneficial interests in securitized financial assets?
2. If the exception in paragraph 14 does not apply to some types of beneficial interests issued in securitization transactions, do those beneficial interests meet the definition of a derivative in paragraph 6 of Statement 133?

The staff’s interim guidance in Implementation Issue D1 stated:

Given the issues outlined above, the staff believes the interpretation of the scope exception in paragraph 14 of Statement 133 and the determination of whether beneficial interests in securitized financial assets meet the definition of a derivative are complex issues that warrant further study....Pending further guidance on those questions, entities may continue to apply the guidance related to accounting for beneficial interests in paragraph 14 and paragraph 233 of Statement 125. Paragraph 14 (as amended) states, “Except for instruments that are within the scope of Statement 133, interest-only strips,

loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115....”[footnote reference omitted.]...The interim guidance is not limited to securitizations involving qualifying special-purpose entities....holders of beneficial interests in securitized financial assets that are not subject to paragraph 14 or paragraph 233 of Statement 125 are not required to apply Statement 133 to those beneficial interests until further guidance is issued.

## RESPONSE

Beneficial interests issued in securitization transactions that are either purchased by third-party investors or held by transferors should first be evaluated to determine if they qualify for the scope exception provided in paragraph 14 of Statement 133. Statement 133 Implementation Issue No. C17, “Application of the Exception in Paragraph 14 to Beneficial Interests That Arise in a Securitization,” provides guidance for determining whether beneficial interests qualify for the exception in paragraph 14.

Beneficial interests that do not meet the scope exception in paragraph 14 should be evaluated to determine whether they meet the definition of a derivative based on the characteristics in paragraph 6 of Statement 133, as follows:

- Paragraph 6(a)—The characteristic of a derivative in paragraph 6(a) is met if the instrument has an underlying (for example, an interest rate or an interest rate index) and a notional amount or payment provision. Both senior and subordinated beneficial interests generally have an underlying. Senior beneficial interests generally have notional amounts indicated by the amount invested to acquire contractual cash flows. Subordinated beneficial interests generally have leveraged terms, which should be incorporated in determining the true notional amount for those contracts.
- Paragraph 6(b)—Statement 133 Implementation Issue No. A20, “Application of Paragraph 6(b) regarding Initial Net Investment,” provides guidance for determining whether the criterion in paragraph 6(b) is satisfied. Based on that guidance, if a beneficial interest is a non-option-based contract that requires an initial net investment that is less than 5 percent of the amount needed to fully prepay the contract, the criterion in paragraph 6(b) is satisfied. If the beneficial interest is an option-based contract (that is, it is a freestanding option or has an embedded option, such as a cap or floor), the criterion in paragraph 6(b) is satisfied if the initial net investment in the contract equals the fair value of the option component. For purposes of analyzing paragraph 6(b), the initial net investment for third-party purchases of beneficial interests is the amount paid by the investor to acquire the contract or its fair value. Similarly, the fair value of a beneficial interest held by the transferor at the time of securitization should be used to make the paragraph 6(b) evaluation (even though the

previous carrying amount allocated to a retained interest under paragraph 10(b) of Statement 140 may not equal the fair value of the retained interest).

- Paragraph 6(c)—The criterion in paragraph 6(c), which describes net settlement, is explained further in paragraphs 9(a)–9(c). Subordinated beneficial interests generally meet the literal requirement of paragraph 9(a)—that neither party is required to deliver an asset that is associated with the underlying or that has a principal amount, stated amount, face value, number of shares, or other denomination that is *equal to* the notional amount—because they generally have notional amounts (as discussed above related to paragraph 6(a)) that are not equivalent to the amount invested to acquire the contract.

If a beneficial interest meets the definition of a derivative in its entirety, that interest should be measured at fair value with changes in value recorded in current earnings in accordance with paragraph 17 of Statement 133. In addition, beneficial interests that meet the definition of a derivative may be designated as hedging instruments subject to meeting the hedge criteria of Statement 133.

If a beneficial interest does not meet the definition of a derivative in its entirety, it should be considered a hybrid instrument that should be evaluated under paragraphs 12–16 to determine if an embedded derivative should be bifurcated. Paragraph 12 states, in part:

An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract....
- b. The contract (“the hybrid instrument”) that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

Implementation Issue A20 indicates that an entity is permitted to account for a non-option-based contract that has an initial net investment that is less than 5 percent of the fully prepaid amount and that, in its entirety, meets the definition of a derivative may be accounted for either as a derivative in its entirety or a hybrid instrument that must be bifurcated into a debt host and a derivative with a fair value of zero at acquisition of the hybrid instrument.

In evaluating whether a beneficial interest that does not meet the definition of a derivative has an embedded derivative requiring bifurcation under paragraph 12, a beneficial interest holder must consider the terms of the beneficial interest itself and the aggregate sources of cash flows that are available to service the interest. That is, beneficial interest holders must consider whether the nature and extent of cash flows generated by the securitized financial instruments are or are not consistent with the stated terms of the interest. Further, the consideration of whether a beneficial interest contains an embedded derivative that must be bifurcated should include the priority of interests (that is, the “cash waterfall”), the relative concentration of risks across various tranches of securities issued by the securitization vehicle, and the nature of any additional credit enhancement or other guarantee available to the interests.

Paragraph 13(a) is important to consider when evaluating beneficial interests that are hybrid instruments. Paragraph 13(a) states, in part:

For purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless...the following [condition] exist[s]:

a. The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover *substantially all* of its initial recorded investment. [Footnote reference omitted.]

Subordinated beneficial interests often can be contractually settled in such a way that the investor would not recover substantially all of its initial recorded investment due to an embedded interest rate derivative. Paragraphs 13 and 61(a) require that such an embedded interest rate derivative be bifurcated.

Statement 133 Implementation Issue No. B12, “Beneficial Interests Issued by Qualifying Special-Purpose Entities,” provides guidance for evaluating beneficial interests issued by a qualifying special-purpose entity, as defined by Statement 140, under paragraph 12 of Statement 133. In addition, other implementation issues provide guidance on the mechanics of bifurcation. Statement 133 Implementation Issue No. B15, “Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument,” indicates that when bifurcation of a hybrid instrument is required, only two components arise out of that instrument—a single compound derivative and a host contract. That is, an entity is not permitted to separate a compound embedded derivative instrument into components representing different risks. Those embedded derivative features must be bundled together as a single, compound derivative instrument that would then be bifurcated and accounted for separately from the host contract under Statement 133.

Further, Implementation Issue B15 indicates that if some of the embedded derivative features in a hybrid instrument are clearly and closely related to the economic characteristics and risks of the host contract, those embedded derivative features should not be included in the compound embedded derivative instrument that is bifurcated from the host contract. Consistent with the logic in Implementation Issue B15, if either prepayment or credit risks are embedded in subordinated beneficial interests and those risks relate only to the securitized assets, then those implicit prepayment or credit derivatives should not be bifurcated from the host contract.

In addition, Statement 133 Implementation Issues No. B20, “Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?” and No. B23, “Terms of a Separated Non-Option Embedded Derivative When the Holder Has Acquired the Hybrid Instrument Subsequent to Its Inception,” indicate that a *non-option-based* embedded derivative should be bifurcated in a manner that results in its fair value generally being equal to zero at the acquisition of the hybrid instrument. In the case of an *option-based* embedded derivative, in accordance with Statement 133 Implementation Issue No. B22, “Whether the Terms of a Separated Option-Based Embedded Derivative Must Produce a Zero Fair Value (Other than Time Value),” the terms of the option-based embedded derivative should not be adjusted to result in the derivative’s being at-the-money at the inception of the hybrid; in separating an option-based embedded derivative from the host contract, the strike price of the embedded derivative should be based on the stated terms documented in the hybrid contract.

Attachment 1 is a flowchart that depicts the model described above for the accounting for beneficial interests under Statement 133. Attachment 2 provides a series of examples illustrating the application of this model.

### **Effective Date and Transition Provisions**

The effective date of the revised implementation guidance in this Issue is the first day of the first fiscal quarter beginning after November 15, 2002, except as discussed below for qualifying special-purpose entities (SPEs) that do not meet the criterion in paragraph 35(c)(2) of Statement 140.

If an entity had not accounted for a beneficial interest as a derivative in its entirety or had not bifurcated an embedded derivative but is required to do so under the revised guidance, the entity should account for the effects of initially complying with the revised implementation guidance prospectively for all existing beneficial interests whether purchased in a third-party securitization or retained by transferors as of the effective date of this Issue, except for the existing contracts that qualify for the grandfathering provisions of paragraph 50, which exempts certain hybrid instruments from the embedded derivative provisions of Statement 133 on an all-or-none basis. (For example, if a company had elected on adoption of Statement 133 pursuant to paragraph 50 to bifurcate only those hybrid instruments acquired or substantively modified after December 31, 1998, the company could not apply newly issued implementation guidance to hybrid instruments

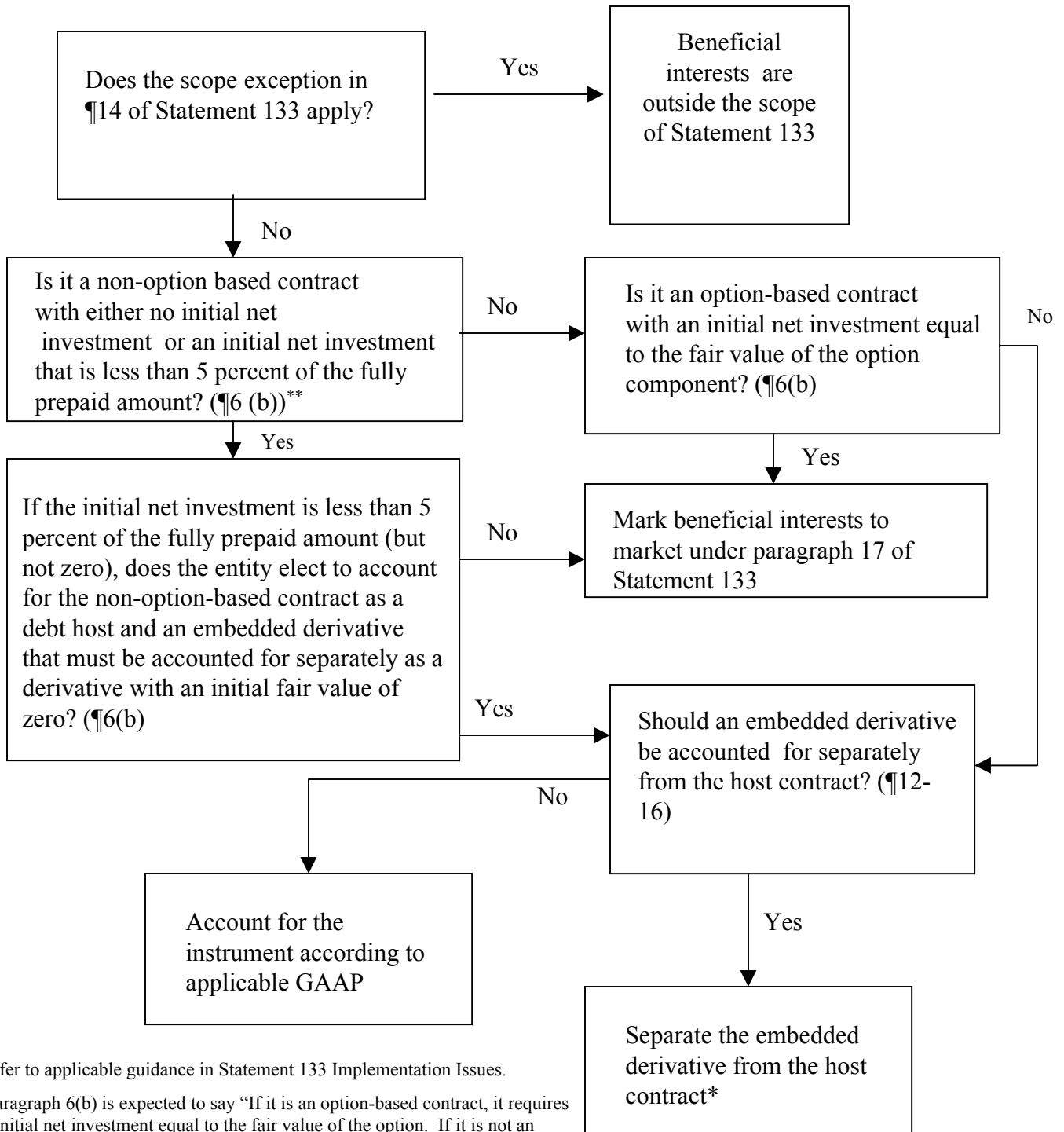
acquired before January 1, 1999.) The effects of initially complying with the revised implementation guidance as of the effective date should be reported as a cumulative-effect-type adjustment of net income. An entity is not permitted to retroactively designate a hedging relationship that could have been established had the interest initially been accounted for as a derivative or had an embedded derivative been accounted for separately.

If the result of applying this guidance is that a qualifying SPE may not meet the criterion in paragraph 35(c)(2) of Statement 140, then that structure is grandfathered from applying the qualifying SPE provisions in Statement 140 so long as that structure issues no additional beneficial interests after [the date that the Exposure Draft to amend Statement 133 is cleared as final guidance]. After that date, if a qualifying SPE issues any additional beneficial interests, then paragraph 55 of Statement 140 should be applied as of that date.

If an entity had been accounting for a beneficial interest as a derivative under Statement 133 but would no longer be able to do so under the revised implementation guidance (because the interest qualifies for the scope exception in paragraph 14 of Statement 133 or because it does not meet the definition of a derivative in paragraph 6 as amended), that accounting should not be changed. The entity should apply the revised guidance prospectively for future transactions only.

*The above response represents a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB and incorporated in an FASB staff implementation guide, which is contingent upon an amendment of Statement 133 being issued. Constituents should send their comments, if any, to Suzanne Bielstein, Director of Major Projects and Technical Activities, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116 (or by e-mail to [derivatives@fasb.org](mailto:derivatives@fasb.org)) by July 1, 2002.*

# Accounting for Beneficial Interests under Statement 133



\*Refer to applicable guidance in Statement 133 Implementation Issues.

\*\*Paragraph 6(b) is expected to say “If it is an option-based contract, it requires an initial net investment equal to the fair value of the option. If it is not an option-based contract, it requires either no initial net investment or an initial net investment that is less than 5 percent of the fully prepaid amount.”

**Example 1**

Two classes of beneficial interests are collateralized by a pool of fixed-rate prepayable loans that have a fair value of \$100 million at the time of securitization.

The senior interest investor (A-class), which represents 80 percent of the fair value of the assets at securitization, receives LIBOR. The interest rate is effectively capped at a rate that is significantly greater than the current market because the A-class can never receive more than 100 percent of the cash flows of the loans.

The subordinated interest investor (B-class), which represents 20 percent of the fair value of the assets at securitization, receives all remaining cash flows, which are essentially the fixed rate minus LIBOR. The B-class is never required to reimburse the A-class (that is, the A-class can never receive more than 100 percent of the cash flows from the loans transferred into the qualifying SPE).

**Paragraph 14 Analysis**

Neither the A-class nor the B-class is eligible for the paragraph 14 scope exception. In this case, the A-class receives cash flows that are indexed to LIBOR. Because LIBOR-based cash flows do not arise from the particular securitized assets, which are fixed-rate loans, the A-class is not eligible for the paragraph 14 scope exception. The B-class absorbs the prepayment risk of the particular securitized loans. While that, in and of itself, does not disqualify the B-class from the paragraph 14 scope exception, its residual return is not the direct fixed-rate cash flows of the particular assets that were securitized. As such, the B-class is also not eligible for the paragraph 14 exception.

**Paragraph 6 (as amended) Analysis**

Neither the A-class nor the B-class meet the characteristic of a derivative in paragraph 6(b) because (1) they are both option-based contracts and (2) they both require an initial net investment that is not equal to the fair value of the option component. Both the A-class and B-class should therefore be analyzed for embedded derivatives in accordance with the guidance in paragraphs 12–16 of Statement 133.

**Paragraph 12 Analysis**

The A-class does not contain an embedded derivative that must be reported separately. The interest rate cap is considered clearly and closely related to the debt instrument and therefore should not be reported separately from the debt in accordance with the guidance in paragraph 61(f) of Statement 133.

The B-class exhibits the economic characteristics of an “inverse floater.” That is, as LIBOR increases, the B-class payments decline. Applying paragraph 13(a) of Statement 133, the B-class would be required to bifurcate a derivative instrument because it is possible that the investor in

the B-class would not recover substantially all of its initially recorded investment. Applying Implementation Issue B15, the B-class investor would bifurcate a capped interest rate swap<sup>1</sup> with a notional amount of \$80 million.<sup>2</sup>

The B-class investor should account for the bifurcated interest rate swap as a derivative instrument under Statement 133 and the host contract like an investment in a debt security under Statement 115 (because it is subject to paragraph 14 of Statement 140).<sup>3</sup>

The B-class investor should account for interest income and impairment of the host contract in securitization transactions that are beneficial interests in securitized financial assets and that are required to be accounted for like debt securities pursuant to paragraph 14 of Statement 140 because they can be contractually prepaid or settled in such a way that the holder would not recover substantially all of its recorded investment in accordance with EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets."

### **Example 2**

Two classes of beneficial interests are collateralized by a pool of prepayable loans that bear floating interests indexed to the prime rate and that had a fair value of \$100 million at the time of securitization.

The senior interest investor (A-class), which represents 80 percent of the fair value of the assets at securitization, receives LIBOR. The interest rate is effectively capped at a rate that is significantly greater than the current market because the A-class can never receive more than 100 percent of the cash flows of the loans.

The subordinated interest investor (B-class), which represents 20 percent of the fair value of the assets at securitization, receives all remaining cash flows, which are essentially the prime rate minus LIBOR. The B-class investor is never required to reimburse the A-class (that is, the A-class can never receive more than 100 percent of the cash flows from the loans transferred into the qualifying SPE).

### **Paragraph 14 Analysis**

Neither the A-class nor the B-class is eligible for the paragraph 14 scope exception. In this case, the A-class receives cash flows that are indexed to LIBOR. Because LIBOR-based cash flows do

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<sup>1</sup>The swap is "capped" because the maximum loss on the swap is \$20 million.

<sup>2</sup> The embedded prepayment derivative would not be bifurcated because the host contract (once the interest rate swap is bifurcated) has only prepayment and credit risks, both of which arise solely from the particular assets being securitized.

<sup>3</sup> The analysis in this and other examples assumes that the holder of any beneficial interest does not intend to subsequently record the hybrid instrument at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur. If that is the case, bifurcation is not required pursuant to paragraphs 12(b) and 16 of Statement 133.

not arise from the particular securitized assets, which are indexed to the prime rate, the A-class is not eligible for the paragraph 14 scope exception. The B-class absorbs the prepayment risk of the particular securitized loans. While that, in and of itself, does not disqualify the B-class from the paragraph 14 scope exception, its residual return is not indexed directly to the prime rate (unlike the cash flows of the particular assets that were securitized). As such, the B-class is also not eligible for the paragraph 14 exception.

**Paragraph 6 (as amended) Analysis**

Neither the A-class nor the B-class meet the characteristic of a derivative in paragraph 6(b) because (1) they are both option-based contracts and (2) they both require an initial net investment that is not equal to the fair value of the option component. Both the A-class and B-class should therefore be analyzed for embedded derivatives in accordance with the guidance in paragraphs 12–16 of Statement 133.

**Paragraph 12 Analysis**

Based on an analysis under paragraph 12 and applying Implementation Issue B12, the A-class does not contain an embedded derivative that must be reported separately. The interest rate cap is considered clearly and closely related to the debt instrument and therefore should not be reported separately from the debt in accordance with the guidance in paragraph 61(f).

The B-class exhibits the economic characteristics of an “inverse floater.” That is, as LIBOR increases, or as the prime rate decreases, or some combination of the two, the B-class payments decline. Applying paragraph 13(a) of Statement 133, the B-class would be required to bifurcate a derivative instrument because it is possible that the holder would not recover substantially all of its initially recorded investment of \$20 million. Applying Implementation Issues B12 and B15, the B-class would bifurcate a capped interest rate swap<sup>4</sup> with a notional amount of \$80 million.<sup>5</sup>

The B-class investor should account for the bifurcated interest rate swap as a derivative instrument under Statement 133 and the host contract like an investment in a debt security under Statement 115 (because it is subject to paragraph 14 of Statement 140).<sup>6</sup>

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<sup>4</sup>The swap is “capped” because the maximum loss on the swap is \$20 million.

<sup>5</sup> The embedded prepayment derivative would not be bifurcated because the host contract (once the interest rate swap is bifurcated) has only prepayment and credit risks, both of which arise solely from the particular assets being securitized.

<sup>6</sup> The analysis in this and other examples assumes that the holder of any beneficial interest does not intend to subsequently record the hybrid instrument at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur. If that is the case, bifurcation is not required pursuant to paragraphs 12(b) and 16 of Statement 133.

The B-class investor should account for interest income and impairment of the host contract in securitization transactions that are beneficial interests in securitized financial assets and that are required to be accounted for like debt securities pursuant to paragraph 14 of Statement 140 because they can be contractually prepaid or settled in such a way that the holder would not recover substantially all of its recorded investment in accordance with Issue 99-20.

**Example 3**

Two classes of beneficial interests are collateralized by a pool of fixed-rate prepayable loans (USD loans) that have a fair value of \$100 million at the time of securitization.

The senior interest investor (A-class) receives interest at a fixed rate in Euros (EUR) [a defacto currency swap with the subordinated interests (receive EUR, pay USD)].

The subordinated interest investor (B-class) receives all remaining cash flows, if any [which are essentially USD minus EUR]. The B-class is never required to reimburse the A-class (that is, the A-class can never receive more than 100 percent of the cash flows from the loans transferred into the qualifying SPE).

**Paragraph 14 Analysis**

Neither the A-class nor the B-class is eligible for the paragraph 14 scope exception. In this case, the A-class receives cash flows that are indexed to EUR. Because the EUR-based cash flows do not arise from the particular securitized assets, which are fixed-rate USD loans, the A-class is not eligible for the paragraph 14 scope exception. The B-class's return is determined by the difference between the fixed-interest-rate cash flows of the securitized assets denominated in USD and the fixed-interest-rate cash flows received by the A-class denominated in EUR. Because the cash flows to be received by the B-class are not the direct fixed-rate cash flows of the particular assets that were securitized, the B-class is not eligible for the paragraph 14 exception.

**Paragraph 6 (as amended) Analysis**

Neither the A-class nor the B-class meet the characteristic of a derivative in paragraph 6(b) because (1) they are both option-based contracts and (2) both require an initial net investment that is not equal to the fair value of the option component. Both the A-class and B-class should therefore be analyzed for embedded derivatives in accordance with the guidance in paragraphs 12–16 of Statement 133.

**Paragraph 12 Analysis**

Based on an analysis under paragraph 12 and applying Implementation Issue B12, the A-class does not contain an embedded derivative that must be reported separately. The interest rate cap is considered clearly and closely related to the debt instrument and therefore should not be reported separately from the debt in accordance with the guidance in paragraph 61(f), and the foreign currency component of a financial instrument is not bifurcated because it is subject to the provisions of FASB Statement No. 52, *Foreign Currency Translation*.

Therefore, the interests would be accounted for as debt securities under Statement 115. If the holder's functional currency is USD and the beneficial interest is classified as held-to-maturity, Statement 52 requires that changes in foreign currency rates be included in income in the current period. Similarly, if classified as available-for-sale, all changes in fair value are included in other comprehensive income as required by EITF Issue No. 96-15, "Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities."

The B-class exhibits the economic characteristics of an inverse, leveraged position in EUR. That is, as EUR increases, the B-class payments decline. Paragraph 15 of Statement 133 states that "unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both *denominated* in a foreign currency...shall not be considered to contain embedded foreign currency derivative instruments..." (emphasis added). The payments on the B-class are not denominated in EUR. Therefore, paragraph 15 does not apply and the embedded USD-EUR capped foreign currency swap with a notional amount of \$80 million must be bifurcated because it is not clearly and closely related to the underlying debt instrument.

The B-class investor should account for the bifurcated USD-EUR capped foreign currency swap as a derivative instrument under Statement 133 and the host contract like an investment in a debt security as defined in Statement 115.<sup>7</sup>

The B-class investor should account for interest income and impairment of the host contract in securitization transactions that are beneficial interests in securitized financial assets and that are required to be accounted for like debt securities pursuant to paragraph 14 of Statement 140 because they can be contractually prepaid or settled in such a way that the holder would not recover substantially all of its recorded investment in accordance with Issue 99-20.

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<sup>7</sup>Refer to footnote 3.

**Example 4**

A company transfers 10,000 shares of XYZ Co. stock (current fair value \$100 per share) to a qualifying SPE in a transfer that meets the requirements for sale accounting under Statement 140.<sup>8</sup>

The qualifying SPE simultaneously enters into a 3-year cash-settled purchased put option on 10,000 shares of XYZ Co. stock with a strike price of \$100 per share with a third party. The option has an initial fair value of \$118,000. The qualifying SPE will enter into no further transactions for three years, at which time the assets will be sold and the options settled. The qualifying SPE then will be dissolved.

The A-class beneficial interests will receive a minimum of \$1 million plus all appreciation in XYZ stock between \$100 and \$137.

The B-class beneficial interests will receive all appreciation in XYZ stock over \$137. That is, the B-class will have the same ultimate cash flows as a purchased call option on XYZ stock with a strike price of \$137. The initial fair value of the B-class is \$118,000.<sup>9</sup>

**Paragraph 14 Analysis**

Neither the A-class nor the B-class is eligible for the paragraph 14 exception. In this case, because the securitized pool contains a freestanding derivative instrument (the purchased put option) at the time of securitization, the beneficial interests fail to meet the paragraph 14(a) criterion.

**Paragraph 6 (as amended) Analysis**

The A-class, although option-based, does not meet the characteristic of a derivative in paragraph 6(b) because it has an initial net investment that is greater than the fair value of the option component of the instrument. Therefore, the A-class should be analyzed for embedded derivatives in accordance with the guidance in paragraphs 12–16 of Statement 133. However, the B-class meets all of the characteristics in paragraph 6. The B-class meets the characteristic of a derivative in paragraph 6(a) because it has an underlying (the share price of XYZ Co.) and a notional amount (\$1 million). The B-class meets the characteristic of a derivative in paragraph 6(b) because the initial net investment is equal to the fair value of the option component. The

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<sup>8</sup> The qualifying SPE has no ability to exercise the voting rights on those shares or choose how to vote.

<sup>9</sup> The \$118,000 “proceeds” is used to purchase the put option (the transferor receives \$882,000 of cash at the inception of the transaction).

B-class meets the net settlement characteristic of a derivative in paragraph 6(c) because neither party is required to deliver an asset that is associated with the underlying or that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount. Therefore, the B-class should be accounted for as a derivative instrument in its entirety.

**Paragraph 12 Analysis**

The A-class would apply Implementation Issues B12, B15, and B22 and No. B19, “Identifying the Characteristics of a Debt Host Contract.” As a result, the A-class would be bifurcated into (1) a zero-coupon bond host with a maturity of 3 years, which is accounted for as a debt security under Statement 115 (assuming the instrument meets the definition of a *security*) and (2) a cash-settled compound derivative instrument with a 3-year term that is composed of 2 call options—a purchased call option on 10,000 shares of XYZ Co. stock with a strike price of \$100 and a written call option on 10,000 shares of XYZ Co. stock with a strike price of \$137,<sup>10</sup> which is accounted for as a derivative instrument under Statement 133.

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<sup>10</sup> This example is being analyzed using the approach proposed in this Issue. It provides an analysis from the beneficial interest holder’s perspective rather than the perspective of the qualifying SPE. As such, while the investor’s position is analyzed as holding a purchased call option, that does not imply that the qualifying SPE holds a purchased call option.

**Title:** Hedging—General: Continuing the Shortcut Method after a Purchase Business Combination  
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**Note:** The guidance in this Issue is tentative and may be finalized if an amendment to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is issued. The Board issued the Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, on May 1, 2002.

## **QUESTION**

Assuming it has already adopted Statement 133, can the acquiror in a business combination accounted for under the purchase method of accounting use the shortcut method of accounting for the hedging relationships of the acquiree that were being accounted for by the acquiree under the shortcut method of accounting at the date of the business combination? (In part, this question entails a determination of whether the purchase business combination results in a new inception date for the combined entity for hedging relationships entered into by the acquiree prior to the consummation of the business combination that remain ongoing at the date of the business combination.)

## **BACKGROUND**

Company A acquires Company B in a business combination accounted for under the purchase method of accounting. Company A and Company B both adopted Statement 133 prior to the date of the business combination. At the date of the business combination, Company A and Company B both have certain hedging relationships that have met the requirements in paragraph 68 of Statement 133 and that are being accounted for by the respective companies under the shortcut method of accounting. Under the purchase method of accounting, a business combination is accounted for as the acquisition of one enterprise by another enterprise. The acquiring enterprise, Company A, records the assets acquired and liabilities assumed at fair value. Assume that, at the date of the business combination, the fair value of the hedging swaps in Company B's hedging relationships is other than zero.

## **RESPONSE**

Yes, if a new hedging relationship is designated by the acquiring enterprise and the criteria in paragraph 68 are met. After applying Implementation Issue A20, "Application of Paragraph 6(b) regarding Initial Net Investment," the applicable hedging relationship can meet the requirements of the shortcut method in paragraph 68 of Statement 133 *at the date of the business combination* because the acquiring enterprise may account for the newly acquired hedging swaps as hybrid

instruments that each must be bifurcated into a debt host and a derivative whose fair value is zero at the inception of the hybrid instrument. For the acquiring enterprise in a purchase business combination, the date of the business combination would be the inception of the newly acquired hedging swaps. The combined organization could choose to designate the swaps and the hedged items as hedging relationships to be accounted for under the shortcut method, provided all the criteria under paragraph 68 are met. Company A is acquiring the individual assets and liabilities of Company B at the date of the business combination and accordingly any pre-existing hedging relationships of old Company B must be designated anew by the combined entity at the date of the business combination in accordance with the relevant requirements of Statement 133. The concept of purchase accounting in FASB Statement No. 141, *Business Combinations*, follows the accounting for acquisitions of individual assets and liabilities. That is, the combined entity should account for the assets and liabilities acquired in the business combination consistent with how it would be required to account for those assets and liabilities if they were acquired individually in separate transactions. The purchase method is based on the premise that in a purchase acquisition, the acquired entity (Company B) ceases to exist and only the acquiring entity (Company A) survives. Thus, the post-acquisition hedging relationship designated by Company A is a new relationship that has a new inception date.

*The above response represents a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB and incorporated in an FASB staff implementation guide, which is contingent upon an amendment of Statement 133 being issued. The Board intends to issue an Exposure Draft proposing an amendment of Statement 133 in the fourth quarter of 2001. Constituents should send their comments, if any, to Suzanne Bielstein, Director of Major Projects and Technical Activities, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116 (or by e-mail to [derivatives@fasb.org](mailto:derivatives@fasb.org)) by July 1, 2002.*