



Board Meeting Handout
Statement 155 Implementation Issues
October 25, 2006

PURPOSE OF THE MEETING

1. The purpose of today's meeting is to address the application of paragraph 14A of FASB Statement No. 133, *Accounting for Derivatives Instruments and Hedging Activities*, to asset backed securities (ABS), including mortgage-backed securities (MBS), created from pools of loans containing embedded call features. Additionally, the Board will decide whether to issue proposed guidance on this issue for public comment.

BACKGROUND

2. FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, amended Statement 133 to, among other things, (a) clarify which interest-only strips and principal-only strips are not subject to the requirements of that Statement and (b) establish a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. Additionally, Statement 155 amended the comment section of example 6 in Statement 133 Implementation Issue No. B39, "Application of Paragraph 13(b) to Call Options That Are Exercisable by the Debtor." The staff has received a significant number of inquiries related to these amendments. The inquiries received by the staff have focused on the analysis of interest rate based derivatives, as credit derivatives are generally exempt from the analysis in accordance with paragraph 14B of Statement 133, as amended. Constituents have requested that the Board provide guidance on the application of paragraph 13(b) to securitized interests.

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3. It is important to note that both the MBS and the underlying financial assets (for example, prepayable mortgage loans) that are the subject of this issue include embedded derivatives. The issue being addressed is not whether they contain a derivative, but when the embedded derivative is required to be separately accounted for in accordance with Statement 133.

PROPOSED SCOPE EXCEPTION

4. To address constituents' concerns, the staff recommends a narrow scope exception for securitized interests that (1) **only** contain an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets, and (2) the investor does not control the right to accelerate the settlement. If a securitized interest contains any other terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument, those securitized interests would be subject to the requirements of paragraph 13(b) of Statement 133 (for example, an inverse floater).
5. To accomplish the objective of implementing a scope exception that is limited to securitized interests that only contain an embedded derivative tied to the prepayment risk of the underlying prepayable financial assets, the staff recommends the following proposed scope exception:

A securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of Statement 133 if it meets all of the following criteria:

- a. The right to accelerate the settlement of the securitized interest can not be exercised by the investor,
 - b. The underlying financial assets do not contain an embedded derivative that requires bifurcation, and
 - c. The securitized interest itself does not contain an embedded derivative that requires bifurcation (including an interest rate related derivative), which is not solely related to the reallocation of prepayment risk inherent in the underlying financial assets.
6. The proposed scope exception has an indirect interaction with the scope exception for interest-only strips and principal-only strips that was provided in Statement 155 (as an

amendment to paragraph 14 of Statement 133). The scope exception in paragraph 14 was intended to be narrow, as discussed in the basis for conclusions to Statement 155. As a result, “an allocation of a portion of the interest or principal cash flows of a specific debt instrument to provide for a guarantee of payments, for servicing in excess of adequate compensation, or for any other purpose would not meet the intended narrow scope of the exception.”

7. The proposed recommendation effectively broadens this scope exception for principal-only strips, because principal-only strips that provide for a guarantee of payments or for servicing in excess of adequate compensation would not meet the paragraph 14 requirements. However, they would be exempt from paragraph 13(b) to the extent that they meet the requirements of the proposed scope exception. This is not the case for interest-only strips as they are analyzed under paragraph 13(a), which is not the subject of the proposed scope exception. It is expected that interest-only strips will meet the requirements of paragraph 13(a) as they generally “can contractually be settled in such a way that the investor (holder) would not recover substantially all of its initial recorded investment.”
8. **Question—Does the Board agree with the proposed scope exception?**

TRANSITION AND EFFECTIVE DATE

9. Statement 155, paragraphs 6 and 7, include the following transition and effective date provisions:

This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of Statement 133 prior to the adoption of this Statement. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year.

At adoption, any difference between the total carrying amount of the individual components of the existing bifurcated hybrid financial instrument and the fair

value of the combined hybrid financial instrument shall be recognized as a cumulative-effect adjustment to beginning retained earnings. An entity shall separately disclose the gross gains and losses that make up the cumulative-effect adjustment, determined on an instrument-by-instrument basis. Prior periods shall not be restated.

10. Assuming that Statement 155 was not early adopted, the earliest effective date was October 1, 2006, for September 30 year-end companies. However, those companies have not yet issued financial statements in which Statement 155 was applied. Therefore, if the proposed guidance is issued and effective prior to the reporting deadline for periods ending December 31, 2006, the staff believes that no transition provisions are required for companies that did not early adopt Statement 155.
11. For entities that early adopted Statement 155, transition provisions may be required depending on how the guidance in Statement 133 (as amended by Statement 155) was applied. The staff has identified the following possibilities for the Board's consideration:
 - a. For entities that early adopted Statement 155 and **did not bifurcate** embedded prepayment derivatives (that is, accounting consistent with the proposed scope exception), no transition provisions are required. However, the staff recommends specifically addressing this scenario to ensure that there is no question over the possibility of restating prior financial statements.
 - b. For entities that early adopted Statement 155, identified embedded derivatives that would otherwise be included in the proposed scope exception, and **elected to measure the entire hybrid instrument at fair value**, the guidance in this issue should be applied retrospectively. The staff recommends that the company be provided with the opportunity to elect any appropriate Statement 115 classification as part of the retrospective application. If the company elects a trading classification under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, no adjustment to the changes in fair value previously recorded in the income statement is required. However, if the company elected a classification of available-for-sale, the retrospective application would result in a reclassification from the income statement to accumulated other comprehensive income.

- c. For entities that early adopted Statement 155 and **did bifurcate** embedded derivatives that would otherwise be included in the proposed scope exception, the staff recommends that the guidance in this issue be applied retrospectively. This would result in the reversal of any changes in the fair value of the embedded derivative that were recorded in income during the prior period. The staff also recommends that the combined instrument be recorded, both initially and subsequently, based on the Statement 115 classification previously elected for the host instrument.
12. **Question—Does the Board agree with the proposed transition and effective date recommendations?**

FORM OF THE GUIDANCE

13. To avoid confusion, the staff recommends that the Board issue the guidance as a Statement 133 Implementation Issue, since guidance on accounting for derivative financial instruments is generally contained in Statement 133 or the related Statement 133 Implementation Issues. To accelerate the issuance of guidance, the staff also recommends that the Board approve a 30-day comment period for the proposed guidance, which is shorter than the 35-day comment period used for Statement 133 Implementation Issues.
14. Based on a 30-day comment period, the staff expects that the Board could analyze the comment letters received and redeliberate this issue in mid-December. This should allow for the issuance of the final guidance in early 2007, before most reporting deadlines for periods ending December 31, 2006.
15. **Question—Does the Board agree that the guidance should be issued as a Statement 133 Implementation Issue?**
16. **Question—Does the Board agree with a 30 day comment period?**