## Statement 133 Implementation Issues

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Topic: Embedded Derivatives: Must the Terms of a Separated Option-Based Embedded Derivative Produce a Zero Fair Value (Other than Time Value) at Inception?

Paragraph references from Statement No. 133: 12

BACKGROUND AND DESCRIPTION OF TRANSACTION

Paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to the Statement if certain criteria are met. The embedded derivative provisions of Statement 133 do not provide explicit guidance regarding whether an embedded derivative must be assumed to have a fair value of zero (that is, be “at the money”) at the inception of the hybrid instrument. The tentative conclusion in Statement 133 Implementation Issue No. B20, “Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?” indicates that in separating a non-option embedded derivative from the host contract under paragraph 12, the terms of that non-option embedded derivative should be determined in a manner that results in a fair value generally equal to zero at the inception of the hybrid instrument. For purposes of this Issue, assume that the hybrid instrument is not a derivative in its entirety.

QUESTION

In separating an option-based embedded derivative from the host contract under paragraph 12, must the terms of that option-based embedded derivative be determined so as to result in the derivative being at-the-money (that is, the strike price equals the price of the asset associated with the underlying, in which case the intrinsic value is zero) and, therefore, a fair value equal to the time value component at the inception of the hybrid instrument?

POSSIBLE ALTERNATIVES

View A
No. In separating an option-based embedded derivative from the host contract under paragraph 12, the strike price of the embedded derivative should be based on the stated terms documented in the hybrid contract. As a result, the option-based embedded derivative may have an off-market strike price at inception (that is, the strike price does not equal the price of the asset associated with the underlying). View A proponents note that generally it will be readily apparent whether the terms of the embedded derivative are at-the-market or off-market at inception of the hybrid instrument since, in order for the embedded feature to meet the definition of a derivative, it must contain an underlying, which is a specified price, rate, or other variable.
The examples included in this issue write-up demonstrate that adjusting the strike price of an option-based embedded derivative fundamentally alters the economics of the hybrid instrument. View A proponents strongly object to the arbitrary adjustment of the strike price of an option-based embedded derivative since to do so results in accounting for instruments that do not exist and, as a result, that accounting will not reflect the economics of the actual instrument. The examples demonstrate that simply adjusting the strike price of the option-based embedded derivative will result in permanent cash flow differences between the actual instrument and the “at-market-adjusted” instrument.

There are substantive, fundamental differences between forward-based and option-based contracts. For example, if an option-based derivative is in-the-money, that intrinsic value amount does not represent a lending activity since the option may never be exercised (that is, it may expire out-of-the-money due to a change in the underlying) and, therefore, a cash flow may not occur by the end of the term. Conversely, the contractual terms of a plain-vanilla forward contract are such that it rarely would fail to be in-the-money at maturity (that is, only on rare occasion would it be at-the-money at maturity). Thus, if the terms of a forward are off-market, that amount effectively represents a borrowing (pursuant to the guidance in Issue B20). A forward contract must involve cash flows calculated based on the difference between the forward rate and the price of the asset associated with the underlying. Certain View A proponents believe that the foregoing fundamental distinctions warrants different guidance on accounting for option-based and non-option-based embedded derivatives.

View A supporters refer to the guidance in Statement 133 Implementation Issue No. B6, “Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative,” as further support for their belief that an option-based embedded derivative can have off-market terms at inception. Otherwise, View A proponents argue, there is no need for the existence of Issue B6. Opponents of View A point out that Issue B6 addresses how to allocate the initial carrying basis of the hybrid instrument when that amount is different than the sum of the fair values of the host contract and the embedded derivative. The guidance in Issue B6 is still needed when an option-based embedded derivative has an at-the-money strike price at inception since that option has a fair value (generally equal to the time value). Thus, in their view, the existence of the guidance in Issue B6 is not relevant to the discussion of the above question.

View B
Yes. In separating an option-based embedded derivative from the host contract under paragraph 12, the terms of that option-based embedded derivative should be determined in a manner that results in an at-the-money strike price at the inception of the hybrid instrument. Proponents of View B believe that it is artificial to structure the terms of an option-based embedded derivative to result in an off-market strike price at the inception of the hybrid instrument. (Conversely, View B opponents argue that it is artificial to structure the terms of an option-based embedded derivative to result in an at-the-money strike price at the inception of the hybrid instrument when the documented legal terms of the embedded derivative may be off-
If an option-based embedded derivative has terms that are off-market at inception, that amount should be quantified and allocated to the host contract since it effectively represents a borrowing.

Certain View B proponents are concerned that entities could purposefully structure the terms of the option-based embedded derivative to achieve specific accounting treatments under a View A approach. Permitting entities to document off-market terms to the option-based embedded derivative effectively will result in the bifurcation of only a portion of the financing component and is the equivalent of simply marking a portion of a debt (or equity) instrument to market. Some View B supporters believe that such flexibility results in selective mark-to-market accounting. In certain circumstances the structuring of terms may not only change the interim earnings recognition, but also may have a permanent, cumulative earnings impact (for example, puttable common stock). Thus, guidance that allows entities to allocate the basis of a hybrid instrument based on the stated contractual terms of the option-based embedded derivative will potentially enable entities to select the earnings result they desire.

Those who support View A strongly object to the assertion that the contractual terms can be arbitrarily adjusted to manipulate the earnings impact. They note that the examples demonstrate that the terms prescribed to the option-based embedded derivative are not arbitrary because those differences clearly have an impact on the ultimate cash flows under the hybrid contract; thus, those differences are substantive.

Any adjustment to an option’s strike price will result in a corresponding change in the time value of that option. Adjusting an off-market strike price to be at-the-money will increase the time value of that option. If an option is deep out-of-the-money, such an adjustment could be characterized as allocating more of the financing element from the host contract to the option-based embedded derivative. Therefore, certain View B opponents assert that such an adjustment could be viewed as conflicting with the guidance in Issue B20.

Certain View A proponents believe that the guidance in View B conflicts with the guidance in Statement 133 Implementation Issue No. A9, “Prepaid Interest Rate Swaps.” Issue A9 indicates that if a contract meets the definition of a derivative in its entirety and that contract also contains a lending activity, Statement 133 does not permit bifurcation of the entire contract into a debt host and embedded derivative with at-the-market terms.

Certain View B proponents note that, under guidance in View B, generally it will be easier for the option-based embedded derivative to qualify as a hedging instrument in a hedging relationship.

Certain View A proponents object to the guidance in View B solely on the basis that they believe that it will unnecessarily result in significant additional administrative and recordkeeping costs. Effectively, under View B entities will have to maintain two sets of records in their accounting systems. First, for custodial and tracking purposes entities must enter into their
systems the legal, contractual terms of the hybrid instruments. Second, they would be required to adjust the option-based embedded derivative’s contractual terms to be at-the-money and then account for that derivative based on those artificial terms.

Hybrid Instruments For Discussion Purposes

Convertible Debt Example

Convertible Bond No. 1
An entity purchases a noncallable convertible bond with a face value and issue price of $1,000. The bond may be converted by the holder into 100 shares of the issuer’s equity. (Results in a strike price (or conversion price) equal to $10 per share = $1,000 par/100 shares.) On the date of issuance, the market price of the issuer’s common stock is $8.33 per share. The hybrid instrument contains (a) a right to receive principal (par amount of $1,000), (b) a right to receive periodic interest payments (at a stated rate of 4 percent), and (c) a conditional right to receive equity shares if the conversion option is exercised. Assuming the application of appropriate pricing models produces a value of $790 for comparable nonconvertible debt and a value of $240 for the conversion option, the $1,000 proceeds would be allocated to the components as follows: (1) $240 for the conversion option and (2) $760 for the debt host contract (based on the with-and-without method pursuant to Issue B6).

Convertible Bond No. 2
An entity purchases a noncallable convertible bond with a face value and issue price of $1,000. The bond may be converted by the holder into 120 shares of the issuer’s equity. (Results in a strike price (or conversion price) equal to $8.33 per share = $1,000 par/120 shares.) On the date of issuance, the market price of the issuer’s common stock is $8.33 per share. The hybrid instrument contains (a) a right to receive principal (par amount of $1,000), (b) a right to receive periodic interest payments (at a stated rate of 3.5 percent — note that this is a lower rate than convertible bond 1), and (c) a conditional right to receive equity shares if the conversion option is exercised. Assuming the application of appropriate pricing models produces a value of $730 for comparable nonconvertible debt and a value of $300 for the conversion option, the $1,000 proceeds would be allocated to the components as follows: (1) $300 for the conversion option and (2) $700 for the debt host contract (based on the with-and-without method pursuant to Issue B6).

Commentary
The two example convertible bonds will provide different cash flows, given a specified market price of the issuer’s common stock. If the market price of the issuer’s common stock at the maturity of the bonds is still $8.33 per share, the holder of convertible bond No. 1 will have earned a higher return (received greater cash flows) then the holder of convertible bond No. 2 due to the different stated rates of interest. If the market price of the issuer’s common stock at the maturity of the bonds has increased to $15 per share and each bond is converted, the holder
of convertible bond No. 1 will receive stock with a value of $1,500 and the holder of convertible bond No. 2 will receive stock with a value of $1,800. The greater value of stock received from the conversion of bond No. 2 over that received from conversion of bond No. 1 is partially offset by the higher interest payments received on bond No. 1 over that received on bond No. 2 prior to conversion. The examples demonstrate that the terms prescribed to the option-based embedded derivative are not arbitrary because those differences clearly have an impact on the ultimate cash flows under the hybrid contract; thus, those differences are substantive.
Topic: Embedded Derivatives: Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value When the Holder Has Acquired the Hybrid Instrument Subsequent to Inception?

Paragraph references from Statement No. 133: 12

BACKGROUND AND DESCRIPTION OF TRANSACTION

Paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to the Statement if certain criteria are met. The embedded derivative provisions of Statement 133 do not provide explicit guidance regarding whether an embedded derivative must be assumed to have a fair value of zero (that is, be “at-the-market”). The tentative conclusion in Statement 133 Implementation Issue No. B20, “Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?” indicates that in separating a non-option embedded derivative from the host contract under paragraph 12, the terms of that non-option embedded derivative should be determined in a manner that results in a fair value generally equal to zero at the inception of the hybrid instrument. That Issue does not address the bifurcation of the embedded derivative by a holder who has acquired the hybrid instrument from a third party subsequent to the inception of that hybrid instrument.

QUESTION

If the holder has acquired the hybrid instrument subsequent to the inception of the hybrid instrument, must the terms of an embedded derivative that is separated from the host contract under paragraph 12 be determined by the holder so as to result in the derivative having a fair value of zero (that is, be “at-the-market”) at the date the holder enters into (that is, acquires) the hybrid instrument rather than at the earlier inception of the hybrid instrument?

POSSIBLE ALTERNATIVES

View A
Yes. In separating a non-option embedded derivative from the host contract under paragraph 12, the terms of that non-option embedded derivative should be determined by the holder in a manner that results in a fair value generally equal to zero (that is, be “at-the-market”) at the date when the holder acquires the hybrid instrument subsequent to the inception of the hybrid instrument—that is, at the date the holder entered into the contract. The rationale in support of View A is the same as that discussed in the tentative guidance for Issue B20. The holder should follow the same process outlined in the tentative guidance for Issue B20 when adjusting the terms of the non-option embedded derivative at the date of acquisition of the hybrid instrument.
Proponents of View A believe that the initial accounting by the holder of the hybrid instrument should not be impacted by whether it purchased the hybrid instrument at inception or subsequent to inception in a secondary market. If a holder acquires a non-option embedded derivative subsequent to inception in a secondary market, in most circumstances the stated terms will be off-market and that amount should be quantified and allocated to the host contract since it effectively represents a borrowing.

**View B**

No. In separating a non-option embedded derivative from the host contract under paragraph 12 when the holder has acquired the hybrid instrument in a secondary market subsequent to the inception of the hybrid instrument, the terms of the embedded derivative should be based on the initial terms that resulted in a fair value generally equal to zero at inception of the hybrid instrument (even though the holder was not then a party to the hybrid instrument). View B supporters believe that it is important to quantify and allocate the borrowing component of the hybrid instrument only at inception of the hybrid instrument. Changes in the fair value of the non-option embedded derivative subsequent to the issuance date (calculated based on a forward price adjusted to be at-the-market at inception) no longer represent a financing component, but instead reflect true market value changes that should be legitimately ascribed to the embedded derivative.

View B supporters believe that when the holder acquires the hybrid instrument in a secondary market subsequent to the inception of the hybrid instrument, only the initial terms that resulted in the non-option embedded derivative having a fair value generally equal to zero at inception of the hybrid instrument will result in a basis allocation to the debt host contract providing an appropriate stated interest rate. To do otherwise, they argue, would drive the debt host off-market and result in an inappropriate stated interest rate. View A proponents disagree with this assertion as they believe that the hybrid instrument will be efficiently priced in the secondary market (in the same manner that the instrument is priced at date of issuance), thereby resulting in a basis allocation to the debt host contract that provides an appropriate stated interest rate.

Opponents of View B believe that it will be difficult for entities that acquire hybrid instruments in the secondary market subsequent to the inception of the hybrid instrument to obtain the necessary data to determine what terms (that is, the adjusted forward price) the non-option embedded derivative needed in order to result in a fair value generally equal to zero at inception.
QUESTION

An issuer considered a debt’s embedded equity-referenced payment provision as a hedge of a common stock investment. At initial application, the embedded derivative required separate accounting. What is the impact of the Statement 133 transition provisions and can the issuer designate the separated derivative in a hedging relationship on a going-forward basis?

BACKGROUND AND DESCRIPTION OF TRANSACTION

Company A owns 10,000 shares of XYZ common stock that is classified as available-for-sale securities in accordance with Statement 115. The original cost of the securities is $100,000. The shares have appreciated in value such that on January 2, 1999 the market value is $1,000,000. Therefore, in accordance with Statement 115, Company A has recorded a credit to other comprehensive income for $900,000 (ignoring any deferred taxes). Wishing to monetize the appreciation of the XYZ shares, Company A issues a debt obligation on January 2, 1999 that is indexed to the market price of XYZ common stock. The principal balance and the proceeds from the obligation is $1,000,000. However, final settlement of the obligation fluctuates with the market price of XYZ common stock. For example, if the price of XYZ common stock rises to $150 per share, the principal repayment amount increases to $1,500,000, if the price declines to $75 per share, the principal repayment amount decreases to $750,000. This index feature is not separable from the debt obligation and the Company A could, at its option, settle the debt obligation by delivery of XYZ shares.

Prior to the adoption of Statement 133, Company A has adjusted the balance of the debt obligation based upon changes in the value of XYZ common stock in accordance with EITF Issue No. 86-28, Accounting Implications of Indexed Debt Instruments (Issue 86-28). While Issue 86-28 requires the debt obligation to be recorded at its settlement amount at each balance sheet date, the Task Force did not reach a consensus on whether changes in the obligation should be recognized as interest expense. Company A, by issuing the indexed debt, had eliminated the risk of loss associated with the XYZ shares. Accordingly, any losses or gains on XYZ shares will be offset by gains or losses on the indexed debt, and both the fair value of the asset and the settlement amount of the debt obligation would be recognized on the balance sheet. As changes in the fair value of available-for-sale securities are recognized in a separate component of stockholders’ equity pursuant to Statement No. 115, Company A has recognized changes in the indexed debt obligation in other comprehensive income (OCI), rather than in the income statement.
It is assumed that the embedded equity-based derivative in the indexed debt instrument is accounted for separately upon initial adoption of Statement 133.

**POSSIBLE ALTERNATIVES**

**View A**
Although the debt obligation was not accounted for as a derivative instrument prior to the initial application of Statement 133, Company A’s risk management documentation identified this transaction as a method to reduce the Company’s exposure to changes in the price of XYZ common stock. (Recognizing the changes in the carrying amount for the indexed debt obligation (for changes in the settlement amount of the liability) in other comprehensive income is evidence of the hedging relationship.) As a result, a pre-existing accounting (as well as economic) hedging relationship implicitly existed between the debt obligation and the changes in the price of XYZ shares. Therefore, Company A should apply the transition guidance in paragraph 52(b), for the relationship that was viewed as a fair value type hedge. Opponents of this view believe that the debt instrument does not meet the definition of a derivative and therefore does not qualify for the cumulative-effect-type adjustments as described at paragraphs 52(b). The amounts in OCI for the changes in the liability’s settlement amount should also be removed and reported as part of the cumulative-effect type adjustment of net income.

The embedded derivative, subsequent to transition to Statement 133, may be designated as the hedging instrument in either a fair value or cash flow hedging relationship.

**View B**
Paragraph 52 of Statement 133 states that the hedging relationship that existed for the derivative instrument prior to the date of initial application determines whether the transition adjustment related to a specific derivative instrument, is recorded in net income or other comprehensive income. Since prior to the initial application of Statement 133 the debt obligation was not accounted for as a derivative instrument, no prior hedging relationship existed, and therefore, the guidance in paragraph 52(d) should be applied in arriving at the transition adjustment.

The embedded derivative, subsequent to transition to Statement 133, may be designated as the hedging instrument in either a fair value or cash flow hedging relationship.
Inquiry Resolved by FASB Staff

**Topic:** Definition of a Derivative: When a Loan Commitment Meets the Net Settlement Criteria

**Paragraph references from Statement No. 133:** 9, 57(c)(2), 291

**QUESTION**

Can a loan commitment or other credit arrangement have the characteristic of net settlement as discussed in paragraph 9 to meet Statement 133’s definition of derivative instrument?

**BACKGROUND**

Loan commitments or other credit arrangements have characteristics similar to option contracts in that they provide the holder with the right but not the obligation to obtain financing on specified terms and may subject the issuer to market risk. Accordingly, before the effective date of Statement 133, loan commitments are included as option-type derivative financial instruments within the scope of FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments. (See paragraphs 35 and 36 of Statement 119.) Statement 133 supersedes Statement 119 with certain disclosure provisions carried forward by amendment to FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments.

**RESPONSE**

Yes. A loan commitment or other credit arrangement (collectively referred to as “credit arrangement”) can meet Statement 133’s definition of derivative instrument if its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or the underlying promissory note is readily convertible to cash. The terms of a credit arrangement generally include a notional amount (the principal amount), an underlying (the specified interest rate), and either no initial net investment or a small net investment (the commitment fee) equivalent to a premium exchanged on other option-type contracts. If a credit arrangement has the characteristic of net settlement described in paragraph 9 of Statement 133, it is a derivative instrument subject to the provisions of Statement 133. Credit arrangements generally do not require or permit net settlement as described in paragraph 9(a) (and related paragraph 57(c)(1)), in which cash (or another asset) is delivered in an amount related to the fair value of the credit arrangement. (The net settlement provisions in paragraph 9(a) are not met if the holder of the credit arrangement can obtain the benefits from that contract only by borrowing funds, and the amount of the benefit received relates directly to the interest on the amount borrowed.)
However, a market mechanism may facilitate net settlement of the credit arrangement or the underlying promissory note may be readily convertible to cash. Paragraph 291 of Statement 133 explains that “a loan commitment would be excluded from Statement 133’s definition of a derivative instrument if it (a) requires the holder to deliver a promissory note that would not be readily convertible to cash and (b) cannot readily be settled net.” Under paragraph 57(c)(2) of Statement 133, a market mechanism exists to facilitate net settlement of a credit arrangement if the credit arrangement can be assigned to a third party enabling either original party to the commitment to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost. In that circumstance, the credit arrangement would be a derivative instrument to both parties to the contract, even if a market mechanism is available only to one of the parties. As discussed in Statement 133 Implementation Issue No. A7, “Effect of Contractual Provisions on the Existence of a Market Mechanism That Facilitates Net Settlement,” a company must assess the substance of an assignment clause included in a credit arrangement to determine whether the assignment clause precludes the assigning party from being relieved of all rights and obligations under the credit arrangement.

In the absence of a market mechanism to facilitate net settlement, the parties to a credit arrangement must consider whether the underlying promissory note is readily convertible to cash. Paragraph 83(a) of FASB Statement of Financial Accounting Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, states that assets that are readily convertible to cash “have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.” For example, a promissory note (such as a mortgage note meeting certain secondary market eligibility requirements) could be readily convertible to cash if there is an active secondary market with quoted prices that can rapidly absorb the quantity held by the lender without significantly affecting the price. The credit arrangement would not be readily convertible to cash if the notional or principal amount of that arrangement to be exchanged is large relative to the daily transaction volume.
Inquiry Resolved by FASB Staff

Topic: Embedded Derivatives: Application of the Exception in Paragraph 14 for Interest-Only Strips and Principal-Only Strips

Paragraph references from Statement No. 133: 12, 13, 14

QUESTIONS

1. What types of interest-only and principal-only strips arising from securitization transactions qualify for the exception in paragraph 14 of Statement 133?
2. Does the exception in paragraph 14 apply to the B-Class certificates in the example transaction in the Background section? If not, do those B-Class certificates contain an embedded derivative that must be accounted for separately?

BACKGROUND

Paragraph 13 of Statement 133 provides that, under the following circumstances, embedded derivative instruments in which the underlying is an interest rate or interest rate index are not considered clearly and closely related to an interest-bearing host contract and, pursuant to paragraph 12, must be separately accounted for:

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.

b. The embedded derivative could at least double the investor’s initial rate of return and could also result in a rate of return that is at least twice what otherwise would be the current market return for a contract that has the same terms as the host contract and that involves a debtor with the same credit quality.

Paragraph 14 provides the following exception to the requirements of paragraph 13:

However, 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 paragraph 12 and 13 and (b) do not incorporate any terms not present in the original financial instrument described above.
**Example**

A portfolio of fixed-rate loans is transferred to a trust and separated into two tranches. The trust issues to investors M-Class debt certificates that provide a return equal to the principal of the loan plus a variable interest payment indexed to LIBOR that resets weekly. The trust also issues an interest-only strip (B-Class debt certificates) representing the residual cash flows from the fixed-rate loan portfolio after payments on the M-Class certificates are made (that is, the variable spread between the fixed-rate loan portfolio and the M-Class certificates). The B-Class certificates effectively act as an inverse floater since an increase in LIBOR will result in a decrease in the residual cash flows allocated to the B-Class certificates, and vice versa. The loan transferor retains the B-Class certificates. The structure includes a wind-down provision in which the M-Class certificates would not be rolled over upon reset of the interest rate, if the fixed-rate loans would not provide sufficient cash flows to pass through the LIBOR-indexed interest payment to the M-Class certificate holders. In that situation, the fixed-rate loans would be sold and the certificate holders would be repaid. Thus, the M-Class certificate holders will recover substantially all, or all, of their investment at settlement. However, because the spread between the fixed-rate loan portfolio and the rate to be paid to the M-Class certificate holders could narrow, the B-Class certificate holders might not recover *substantially all* of their initial investment. This example assumes that the B-Class and M-Class certificates do not meet the definition of a freestanding derivative instrument pursuant to paragraphs 6–9 of Statement 133 and that the holders of the B-Class and M-Class certificates classify those investments as available-for-sale pursuant to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

**RESPONSES**

**Question 1**

In order for an interest-only or principal-only strip to qualify for the exception provided in paragraph 14, two conditions must be satisfied. Condition (a) requires that the interest-only strip or principal-only strip 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. That condition would be satisfied if, for example, an interest-only or principal-only strip arose from securitization of plain-vanilla prepayable mortgage loans. However, that condition would not be satisfied if, for example, an interest-only or principal-only strip arose from securitization of a hybrid instrument involving a debt host and an embedded equity derivative.

Condition (b) of paragraph 14 requires that the interest-only strip or principal-only strip does not incorporate any terms not present in the original securitized assets serving as collateral for the beneficial interests. That condition would be satisfied if the cash flows of an interest-only or principal-only strip reflected only cash flows generated by the securitized assets, with no adjustment to those cash flows reflecting the impact of other instruments, events, or external factors not present in the original financial instrument.
For example, interest-only strips originated by securitizing a pool of prepayable, fixed-rate loans, which do not themselves contain any embedded derivatives, that have as their cash flows the unaltered fixed interest cash flows arising from the loans in the pool would qualify for the exception in paragraph 14. Paragraph 14 permits the investor in the interest-only strips not to separately account for an embedded derivative that would otherwise be required to be separated under paragraph 13(a) of Statement 133 because it is possible that the effect of prepayments could cause the investor not to recover substantially all of its initial net investment. Similarly, principal-only strips originated by the securitization of prepayable, fixed-rate loans that have as their cash flows the unaltered principal cash flows arising from the loans in the pool would qualify for the exception in paragraph 14. Paragraph 14 permits the investor not to separately account for an embedded derivative that would otherwise be required to be separated under paragraph 13(b) of Statement 133 because it is possible that the effect of prepayments could cause the investor to double the initial rate of return on its investment (the investor’s return increases the sooner repayment at par is received).

However, if interest-only strips have different cash flow characteristics from the original securitized assets (for example, the pool contains floating-rate loans indexed to the Prime rate and the interest-only strips are indexed to 3-month LIBOR), the exception in paragraph 14 does not apply because the interest-only strips incorporate terms (cash flows) that are different from the assets in the pool. Similarly, if interest-only strips are originated by securitization of a pool that includes both nonderivative and derivative instruments, and the cash flows of the interest-only strips reflect the cash flows of the nonderivative instruments as adjusted by the derivatives (for example, the pool contains fixed rate loans and a receive-floating, pay-fixed interest rate swap, and the interest-only strip has floating cash flows), the interest-only strips do not qualify for the exception in paragraph 14 because they incorporate cash flows that are different from the cash flows of the original nonderivative instruments in the pool.

Consistent with the guidance above, Statement 133 Implementation Issue No. C4, “Interest-Only and Principal-Only Strips,” stipulates that the scope exception in paragraph 14 may not be applied when the payments on interest-only and principal-only strips are contingently reallocated based on the occurrence of an event or circumstance which was not present in the original financial instrument, such as a change in interest rates. However, Issue C4 permits the exception to be applied if the cash flows of the original financial instrument are allocated among the interest-only and principal-only components based on contractual terms. Issue C4 does not restrict application of the exception in paragraph 14 to situations in which an interest-only strip receives only interest cash flows from securitized assets or a principal-only strip receives only principal flows from securitized assets. For example, the cash flows from the original financial instrument could be divided into an “interest-plus” component and a principal-only component in which the holder of the interest-plus component receives 100 percent of interest payments plus a percentage of the principal payments (for example, 10 percent) and the holder of the principal-only component receives the remaining percentage of the principal payments (for example, 90 percent).
Question 2
No. In the example transaction in the Background section, the exception in paragraph 14 does not apply to the B-Class certificates. In that example, the underlying cash flows of the fixed-rate loans are being reallocated to the B-Class and M-Class certificate holders on a weekly basis based upon changes in LIBOR. An increase in interest rates will require greater cash flows to be allocated to the M-Class certificate holders (higher interest rate due to the reset) and lower cash flow levels will be available to the B-Class certificate holders. Therefore, since the allocation of cash flows is not associated with the original financial instrument, the exception in paragraph 14 does not apply to the B-Class certificates. (Note that because the M-Class certificates are neither principal-only nor interest-only strips, the exception in paragraph 14 is not applicable.)

The guidance in Statement 133 Implementation Issue No. B12, “Embedded Derivatives in Beneficial Interests Issued by Qualifying Special-Purpose Entities,” requires that both the B-Class certificates and the M-Class certificates (both classified as available-for-sale securities) must be evaluated under paragraph 12 to determine if they contain an embedded derivative that must be separately accounted for. Issue B12 requires that a beneficial interest in debt form that is issued by a QSPE must be evaluated under paragraph 12 similar to other debt instruments that may contain terms that affect some or all of the cash flows in a manner similar to a derivative instrument. That evaluation should focus on only the terms and conditions of the certificate and not the detailed holdings of the QSPE.

Both the B-Class and the M-Class certificates contain debt host contracts. In the case of the M-Class certificates, the variable interest rate is clearly and closely related to the debt host since it does not meet the conditions in paragraph 13. As such, the M-Class certificate does not contain an embedded derivative that must be separately accounted for. However, because the B-Class certificate holder may not recover substantially all of its initial recorded investment due to the reallocation of the cash flows, the reset feature represents an embedded derivative that is not clearly and closely related to the debt host pursuant to paragraph 13(a). Thus, the embedded derivative in the B-Class certificate must be separately accounted for.

However, if the certificates were measured at fair value with changes in fair value reported currently in earnings because the holder had classified the investment as a trading security pursuant to Statement 115, separation of the host contract and the embedded derivative would not be required by Statement 133.
Question Resolved By FASB Staff

**Topic:** Scope Exceptions: Application of the “Regular-Way” Security Trades Exception to When-Issued Securities

**Paragraph references from Statement No. 133:** 10(a), 58(a), 276

**QUESTION**

Assume a variety of forward contracts exist for a specific to-be-announced (TBA) security that provide a choice for settlement at 30 days, 60 days, or 90 days. Company A enters into a forward to purchase the TBA security, which will otherwise meet the qualifications of paragraphs 10(a) and 58(a) that requires delivery in 60 days. May Company A apply the regular-way security trade exception to the 60-day TBA forward contract?

**BACKGROUND**

Paragraph 10(a) of Statement 133 provides an exception to forward contracts that require the delivery of a security within the time frame generally established by regulations or conventions in the marketplace in which the transaction is executed. To qualify for this exception, the security to be delivered must be readily convertible to cash and there cannot be a net settlement provision (based on paragraph 9(a)) or a market mechanism (based on paragraph 9(b)) that would permit or require net settlement of the contract.

Paragraph 276 indicates that the Board decided to extend the regular-way exception to purchases and sales of when-issued and TBA securities “only if (a) there is no other way to purchase or sell the security and (b) the trade will settle within the shortest period permitted for the security.”

**RESPONSE**

No. The regular-way security trade exception may be applied to forward contracts for TBA or when-issued securities provided that delivery of the security is within the shortest period permitted for the security. In the example above, the TBA security is available under multiple settlement periods (30 days, 60 days, or 90 days). The exception may only be applied to forward contracts for this TBA security that require delivery within 30 days, the shortest period permitted for that security. The 60-day and 90-day forward contracts in this example must be accounted for as derivatives under Statement 133. If they meet the hedge accounting criteria, they may be designated as cash flow hedges of the anticipated purchase of the securities.
Inquiry Resolved by FASB Staff

Topic: Hedging--General: Excluded Components of an Option’s Time Value
Paragraph references from Statement No. 133: 30(a), 63

QUESTION

May a company define the excluded component of an option’s time value in a manner other than those specified in paragraphs 63(a) and 63(b) of Statement 133?

BACKGROUND

Paragraph 63 of Statement 133 states, in part:

In defining how hedge effectiveness will be assessed, an entity must specify whether it will include in that assessment all of the gain or loss on a hedging instrument. This Statement permits (but does not require) an entity to exclude all or part of the hedging instrument’s time value from the assessment of hedge effectiveness, as follows:

a. If the effectiveness of a hedge with an option contract is assessed based on changes in the option’s intrinsic value, the change in the time value of the contract would be excluded from the assessment of hedge effectiveness.

b. If the effectiveness of a hedge with an option contract is assessed based on changes in the option’s minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract would be excluded from the assessment of hedge effectiveness.

Paragraph 30(a) of Statement 133 defines an option’s time value as “the fair value of the option less its intrinsic value.” Statement 133 does not define intrinsic value.

FASB Statement No. 123, Accounting for Stock-Based Compensation, provides the following definition:

Intrinsic value
The amount by which the market price of the underlying stock exceeds the exercise price of an option. For example, an option with an exercise price of
$20 on a stock whose current market price is $25 has intrinsic value of $5.

RESPONSE

No. Paragraph 63 provides a finite list of alternatives for excluding all or part of a hedging instrument’s time value from the assessment of hedge effectiveness. With respect to options, paragraph 63 explicitly allows a company to exclude the change in an option’s (a) time value or (b) volatility value. An entity may not define the excluded component of an option’s time value as some other component (for example, an amount related only to vega or only to theta).

Therefore, in hedging relationships involving options as the hedging instruments, paragraph 63(a) permits the assessment of hedge effectiveness to be based on changes in the option’s intrinsic value (that is, changes in the difference between the strike price and the spot price of the underlying instrument). Under paragraph 63(a), changes in the fair value of the option attributable to all aspects of time value (that is, volatility value and the effect of discounting) would be recorded in current earnings. Paragraph 63(b) permits the assessment of hedge effectiveness to be based on changes in the option’s “minimum value” (that is, changes in the total of the intrinsic value and the effect of discounting). Under that paragraph, only changes in fair value of the option attributable to volatility value would be recorded in current earnings.
Inquiry Resolved by FASB Staff

**Topic:** Hedging—General: How Paragraph 68(c) Applies to an Interest Rate Swap that Trades at an Interim Date

**Paragraph references from Statement No. 133:** 68(c)

**QUESTION**

Does a swap that involves a stub period violate the paragraph 68(c) requirement that “the formula for computing net settlements under the interest rate swap is the same for each net settlement” such that the shortcut method may not be applied?

**BACKGROUND**

Paragraph 68 of Statement 133 sets for the requirements that must be met to assume no ineffectiveness in a hedge with an interest rate swap (the shortcut method). Paragraph 68(c) states, “The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)”

Interest rate swaps with floating rates based on LIBOR reset at three-month or six-month intervals. Often, swaps may trade on interim dates that do not correspond to a swap reset date. Calendar dates that are swap reset and payment dates are set by market convention. A swap that resets quarterly may have a first payment period that is shorter than a full quarter, such as 30 days versus 90 days. Because the first payment period is not equal to a full quarter, it is referred to as a “stub period.” That stub period is defined as the period that begins on the date coupon payments begin to accrue and ends on the first payment date. The floating rate set for that shorter period is the “stub rate.” The stub rate is the floating rate that corresponds to the length of the stub period. Therefore, it is unclear whether the existence of the stub rate would violate the requirement in paragraph 68(c) that the “…variable rate is based on the same index and includes the same adjustment or no adjustment.”

**RESPONSE**

No. The existence of a stub period and stub rate is not a violation of paragraph 68(c) that would preclude application of the shortcut method provided that the stub rate is the floating rate that corresponds to the length of the stub period. It is acknowledged that the stub rate presents an apparent inconsistency with the requirement in paragraph 68(c) that the “…variable rate is based on the same index and includes the same adjustment or no adjustment,” because the stub rate is
a floating rate that is adjusted to reflect the number of the days in the stub period, and is therefore not reflective of a floating rate that is applicable to a full reset period similar to the floating rates that would be in effect for the remaining periods of the swap. However, the existence of the stub rate is a market convention that is necessary for determining the price of interest rate swaps that are traded on dates that do not coincide with swap reset dates. Because many swaps are traded on interim dates, the existence of a stub rate for a single period is a necessary adjustment in a significant number of contracts. The objective of the conditions in paragraph 68 for qualifying for the shortcut method are to ensure that the hedging relationship does not violate the assumption of no ineffectiveness necessary for applying the shortcut method. The adjustment of the swap’s floating rate in a stub period as a necessary pricing adjustment does not introduce present an inconsistency with the assumption of no ineffectiveness in a hedging relationship.
Inquiry Resolved By FASB Staff

Topic: Cash Flow Hedge: Use of Shortcut Method for Cash Flow Hedge of Variable Rate Operating Lease

Paragraph references from Statement No. 133: 68, 438

QUESTION

Statement 133 allows the application of the shortcut method (as discussed in paragraphs 114 and 132) to a hedging relationship of interest rate risk involving an interest-bearing asset or liability and an interest rate swap that meets the criteria in paragraph 68. Can the entity ever apply the shortcut method to a cash flow hedge of the variability in lease payments for an interest-rate-indexed operating lease?

BACKGROUND

Paragraph 68 provides the following guidance on qualifying for the shortcut method:

An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest-bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries. An entity may assume no ineffectiveness in a hedging relationship of interest rate risk involving an interest-bearing asset or liability and an interest rate swap if all of the applicable conditions in the following list are met:

Conditions applicable to both fair value hedges and cash flow hedges
a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability.
b. The fair value of the swap at its inception is zero.
c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)
d. The interest-bearing asset or liability is not prepayable.
e. Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.

Conditions applicable to fair value hedges only
f. The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.
g. There is no floor or ceiling on the variable interest rate of the swap.
h. The interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).

Conditions applicable to cash flow hedges only

i. All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.

j. There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)

k. The repricing dates match those of the variable-rate asset or liability.

l. The index on which the variable rate is based matches the index on which the asset or liability’s variable rate is based.

Forexample, an entity leases property under a lease agreement that provides for rental payments indexed to changes in interest rates and accounted for as an operating lease. The payments on the lease agreement are reset quarterly based on changes in 3-month LIBOR. To hedge the variability in expected future cash flows attributable to interest rate risk, the entity enters into a pay-fixed/receive-variable interest rate swap based on 3-month LIBOR and designates the swap as the hedging instrument in a cash flow hedge of the variability in the lease payments. Assume that the term, notional amounts, repricing dates, and maturity on the operating lease and the interest rate swap match and the fair value of the interest rate swap at the inception of the hedge is zero.

RESPONSE

No, the shortcut method may not be applied to a cash flow hedge of the variability in lease payments for an interest-rate-indexed operating lease. Under FASB Statement No. 13, Accounting for Leases, a capital lease is reported as a leased asset and an interest-bearing obligation. However, under Statement 13, an operating lease is accounted for as an executory contract that is not recognized as an interest-bearing asset or liability. The shortcut method may not be applied to a hedging relationship that does not involve an interest-bearing asset or liability. In the above example, the contract is a lease agreement with an escalation clause whose rental payments are dependent on interest rate levels; the contract is not an interest-bearing financial instrument for accounting purposes. Thus, the shortcut method cannot be applied to an operating lease.

Paragraph 438 indicates that Statement 133 “permits an unrecognized firm commitment,
including one that is embodied in an unrecognized asset or liability such as an operating lease with substantial cancellation penalties, to be designated as the hedged item in a fair value hedge.” Although an unrecognized operating lease may be a hedged item (as a firm commitment) in a fair value hedge, it nevertheless fails to qualify for application of the shortcut method because it is not an interest-bearing asset or liability as required by paragraph 68.