MINUTES

Financial Accounting Standards Board

To: Board Members

From: Statement 133 Amendment Team (Busch, ext. 211)

Time Code: A FI-BINT

Subject: Minutes of the November 20, 2002 Board Meeting

Date: November 27, 2002

cc: Bielstein, Leisenring, Smith, Swift, Polley, Cassel, Bullen, Lott, Derivatives Implementation Team, Financial Instruments Team, Gabriele, Sutay, Thompson, Vincent (2)

Topic:	Issues Raised in Comment Letters on the Proposed Amendment to Statement 133
Basis for Discussion:	Staff memorandum dated November 7, 2002
Length of Discussion:	Starting Time: 11:30 a.m.
	Concluding Time: 11:40 a.m.
Attendance:	
Board members present:	Herz, Foster, Schieneman, Trott, and Wulff
Board members absent:	Crooch and Schipper
Staff in charge of topics:	Lusniak, Busch
Other staff at Board table:	Smith, Wilkins, Lynn, and Martin
Outside participants:	None

Matters Discussed, Decisions Reached, and Follow-up Action:

At the November 20, 2002 meeting, the Board continued its redeliberations of issues raised in connection with the accounting for derivative instruments in the FASB Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*.

The Board redeliberated the application of the shortcut method previously discussed at the September 11, 2002 meeting. The Board decided that in order to qualify for the shortcut method, an entity would be required to receive the premium for the written call option embedded in the swap and pay the premium for the purchased call option embedded in the interest-bearing asset or liability in a similar manner. In particular, the Board decided that for callable debt in which the premium for the purchased call option is incorporated as an adjustment of the stated interest rate rather than as a discounted issue price for the debt, paragraph 68(b) would require that the hedging instrument (composed of an interest rate swap and an embedded mirror-image call option) have a fair value of zero at the inception of the hedge.

Discussion

At the September 11, 2002 Board meeting, the staff recommended, and the Board approved, requiring entities that hedge callable debt with a callable swap to receive the premium from the call option of the swap in the form of an up-front payment in order to qualify for the shortcut method.

In response to the Board's decision at that meeting, constituents commented that the use of a callable swap whose initial fair value is equal to the option's time value was (1) inconsistent with the way options markets operate and (2) less effective than a callable swap with an initial zero fair value when hedging interest rate risk of a callable debt instrument that was issued at par. They also provided the staff with market data that indicates that the September 11, 2002 decision results in a less effective hedge.

The staff stated that because an entity is allowed to qualify for the shortcut method when hedging callable debt that embeds the call premium by adjusting the interest rate of the bond, the staff now believes that the entity should be required to receive the premium for the written call option on the swap in a similar manner. The staff believes that requiring the written and purchased calls to be structured similarly helps ensure the calls are mirror images as required by paragraph 68(d) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

For example, the staff noted that when hedging callable debt in which the premium for the purchased call option is incorporated as an adjustment of the stated interest rate rather than as a discounted issuance price for the debt, paragraph 68(b) would require that the hedging instrument (composed of an interest rate swap and an embedded mirror-image call option) have a fair value of zero at the inception of the hedge.

The Board considered the data provided by constituents and decided to modify the criterion for the shortcut method in paragraph 68(b) of Statement 133 to require that, to meet that criterion, the payment for the call option premium on the callable bond (hedged item) and the callable swap (hedging instrument) must be structured similarly.

General Announcements:

None

Summary for ACTION ALERT:

Same as the two paragraph of Matters Discussed…