

MINUTES



To: Board Members

From: Project Team (Cowan, ext. 233)

Minutes of the December 20, 2006
Board Meeting: Statement 133
Implementation Issue No. B40,

Subject: “Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets” **Date:** December 22, 2006

cc: Smith, Bielstein, MacDonald, Golden, Leisenring, Swift, Polley, Carney, Wilkins, Fanzini, Trench, Roberge, Cowan, Arveseth, Stoklosa, Jacobs, Gabriele, Francis (IASB), FASB Intranet

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board’s deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic: Implementation Issue B40—Comment Letter Analysis and Issuance as Final Guidance

Basis for Discussion: Memorandum No. 3, dated December 14, 2006

Length of Discussion: 11:20 a.m. to 11:50 pm

Attendance:

Board members present: Herz, Batavick, Crooch, Linsmeier, Seidman, Trott, and Young

Board members absent: None

Staff in charge of topic: Jacobs

Other staff at Board table: Smith, Stoklosa, and Cowan

Outside participants: None

Summary of Decisions Reached:

The Board decided:

1. To eliminate criterion (b) from proposed Implementation Issue B40, which requires an entity to look through to the assets underlying the securitized interests to evaluate whether those assets contain any embedded derivatives.
2. For certain instruments, to delay the effective date of criterion (c) in proposed Implementation Issue B40, which requires an entity to evaluate whether its securitized interest(s) contain an embedded derivative for which bifurcation would be required other than an embedded derivative that results solely from the embedded call options in the underlying financial assets. Criterion (c) would not have to be applied to securitized interests that (a) were issued before a certain date that will be specified in the final Implementation Issue and (b) include other embedded derivatives that have a fair value of zero (or close to zero) at the effective date of Statement 155.
3. To address other issues in drafting the final Implementation Issue, including changes to the transition guidance of Implementation Issue B40 to include other fact patterns suggested in constituents' comment letters.
4. To issue Implementation Issue B40 as final guidance as soon as practicable.

Objective of Meeting:

The objective of the meeting was to provide the Board with an analysis of the comment letters received regarding Implementation Issue B40 and to get approval to issue the Implementation Issue as final guidance. The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

Background

1. Mr. Jacobs stated that on November 7, 2006, the Board issued proposed Implementation Issue B40 for an accelerated 30-day public comment period. He explained that the comment period ended on December 8, 2006 and as of December 19, 2006, 18 comment letters had been received.
2. Mr. Jacobs further explained that the majority of respondents agreed with the objectives of the Board in this project and commended the Board for its

prompt response to this issue. However, he stated that a majority of respondents noted that the proposed guidance would not provide relief for a significant number of securitized interests and that the guidance did not meet the objectives for the project.

3. Mr. Jacobs stated that the staff agrees with respondents that the conditions included in the proposed Implementation Issue would limit the applicability of the scope exception beyond what the staff had initially intended. He further explained that the two main issues identified by respondents were (a) the look-through provisions in criterion (b) and (b) the effect of insignificant derivatives commonly contained in securitized interests (or criterion (c)).

Look-through Provisions (criterion (b))

4. Mr. Jacobs stated that multiple respondents noted that it is difficult, if not impossible, to analyze all of the assets that support each of the securitized instruments that they hold as investments, as required by the proposed Implementation Issue. He explained that respondents also noted that the requirement that the underlying financial assets not contain an embedded derivative that requires bifurcation is inconsistent with the assessment of freestanding derivatives held by the securitization trust.
5. Finally, Mr. Jacobs stated that respondents noted the requirement to “look through” to the underlying assets did not capture structuring opportunities that would not be identified in criterion (c) and, therefore, added significant cost without equal benefit.

Insignificant Derivatives with the Securitized Instruments (criterion (c))

6. Mr. Jacobs stated that respondents questioned why an immaterial derivative (for example, a paragraph 13(a) derivative) should preclude a securitized instrument from meeting the scope exception in the proposed Implementation Issue. That is, if the Board does not intend for prepayment risk in securitized financial assets to be bifurcated, why would that principle change when there are other embedded derivatives in the instrument. Those respondents noted

that a significant portion of securitized interests contain insignificant embedded derivatives that require bifurcation and would therefore technically meet this criteria. Respondents explained that those derivatives often result from terms that meet the existing criteria in paragraph 13(a) when extreme or remote interest rates are considered. Mr. Jacobs stated that examples were provided in the Board meeting handout and Board Memorandum No. 3.

Staff Recommendation

7. Mr. Jacobs stated that, based on the comments received on these two issues, the staff believes that the specific eligibility criteria in proposed Implementation Issue B40 should be amended and that the amendments are required to meet the original objectives of this project. He explained that the amendments are not to broaden the scope of the issue beyond the original intent, but because, as previously written, the criteria in Implementation Issue B40 would result in few instruments being eligible for the scope exception and, therefore, limits the benefit of providing the guidance.
8. Additionally, Mr. Jacobs noted that the staff also acknowledges that the scope exception was designed to be narrow and was not intended to be equivalent to reinstating Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets." He stated that these conflicting objectives make it difficult to provide a simple solution to the issues addressed in Implementation Issue B40.
9. Mr. Jacobs stated that the staff recommends the following amendments:
 - a. Criterion (b) should be removed as criterion (c) will appropriately identify instruments that are considered complex and outside of the scope of this exception, and for the other reasons discussed above.
 - b. Criterion (c) should be retained with a delayed effective date. That is, an instrument would not be subject to this criterion if (1) it was issued before a certain date (for example, June 30, 2007), and (2) the other embedded derivative which requires bifurcation has a fair

value of zero (or close to zero) at the effective date of Statement 155.

Board Discussion

10. Mr. Trott stated that he continues to disagree with the proposed Implementation Issue because prepayment risk exists and securitizations, in many cases, are intended to shift that risk in a specific way. Because of the presence of this risk and the opportunity to shift that risk, an evaluation under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, should be performed. He explained that the comments received from constituents did not provide information that changed his view.

11. Mr. Herz stated that he did not believe that the proposed Implementation Issue would fix the fundamental problem with paragraph 13 and that he was concerned that future issues involving paragraph 13 would come to the Board. Because of this, he stated that he preferred delaying the removal of Implementation Issue D1 while the staff addressed the fundamental problem with paragraph 13. Mr. Trott stated that concerns would inevitably come to the Board's attention in the future, but eliminating Implementation Issue D1 was one of the primary reasons for FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*.

12. Ms. Seidman explained that, while she did not prefer the staff's recommendation, she recognizes that the staff's recommendation is a practical solution that will likely get the same results of other alternatives such as the one discussed by Mr. Herz and, for that reason, she supports the staff recommendation. She stated that, given more time, she would like to use the *substantive features* concept developed in the liabilities and equity project in this area. Ms. Seidman stated that it is not good financial reporting to allow insignificant items that only have a material impact in remote scenarios to drive the accounting treatment.

13. Mr. Linsmeier expressed concern that the narrow scope exception that the staff initially developed is being expanded because of the input received in

comment letters. He explained that he was concerned about expanding the scope of the proposed Implementation Issue to more complex arrangements (for example, securitized interest with multiple embedded derivatives) without analyzing what types of instruments would be scoped out as a result. Mr. Linsmeier stated that he did not support the staff's recommendation because of his concerns and explained that the Board needed to address materiality in paragraph 13 for remote scenarios or use a nonsubstantive features approach as explained by Ms. Seidman. Mr. Linsmeier stated that he would rather have a targeted delay for the urgent issue at hand and address paragraph 13 by developing a more thorough solution. Mr. Crooch stated that he did not agree with the staff's recommendation for similar reasons to Mr. Linsmeier.

14. Mr. Batavick stated that the staff had done a good job in developing a practical solution. He explained that he shared Mr. Herz's concerns; however, the proposed Implementation Issue is the result of comments from the parties that will be most affected and, therefore, he supports the staff's recommendation. Mr. Young stated that he agreed with Mr. Batavick. Mr. Herz stated that he would also accept the staff's recommendation, still noting that the fundamental problem with paragraph 13 would not be addressed by the Implementation Issue B40. He stated that Ms. Seidman's idea of borrowing the nonsubstantive features concept from the liabilities and equity project was a good idea.

15. The Board agreed with the staff's recommendation by a vote of four (RHH, GJB, LFS, and DMY) to three (GMC, TJL, and EWT). Mr. Trott was the only Board member who stated that he would be writing an alternative view to Implementation Issue B40. Mr. Herz directed the staff to determine the proper amount of time to delay the application of criterion (c) in Implementation Issue B40 for certain instruments during the drafting process.

Other Issues

16. Mr. Jacobs stated that the staff also received other comments regarding the transition provisions, the scope of the proposed Implementation Issue, certain other issues, and editorial changes that the staff recommends dealing with in drafting the final guidance. The Board unanimously agreed with the staff's recommendations regarding those other issues.

17. Mr. Jacobs asked if the Board approved of the staff redrafting the proposed Implementation Issue and proceeding to a Ballot Draft (with the goal of final issuance in early to mid-January 2007). The Board unanimously agreed that the staff should proceed to a vote by written ballot following the changes discussed at the meeting.

Follow-up Items:

Determine the length of the delay for criterion (c) during the drafting process.

General Announcements:

None.