

MINUTES



To: Board Members

From: Beneficial Interests Team (Varian, ext. 353)

Subject: Minutes of the December 22, 2004 Board Meeting **Date:** January 7, 2005

cc: Bielstein, L. Smith, Petrone, Wilkins, Lott, E. Smith, Laurenzano, Varian, Bullen, Donoghue, Lusniak, Getz, Gabriele, Sutay, FASB Intranet

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Topic: Beneficial Interests in Securitized Financial Assets—Evaluation for Identification of Embedded Derivatives

Basis for Discussion: Memorandum 10

Length of Discussion: 10:30 a.m. to 11:00 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schieneman (by phone), Schipper, Seidman, and Trott

Board members absent: None

Staff in charge of topic: E. Smith

Other staff at Board table: L. Smith, Wilkins, Laurenzano, Hamilton, Hansen

Outside participants: None

Summary of Decisions Reached:

The Board discussed guidance for identifying and evaluating embedded derivatives in beneficial interests in securitized financial assets. In situations when that identification and evaluation will be based on the terms of the interests themselves, the Board decided that the phrase *the terms of the interests themselves* refers to all of the information that describes those interests. That information can generally be found in the prospectus and in other documents such as the indenture or certificate that specifies the interest's conditions and priorities as to cash flows. However, the Board also decided to clarify that the objective is to obtain sufficient evidence to determine whether there is an embedded derivative requiring bifurcation in the beneficial interest. If there is not sufficient evidence to make that determination in the terms of the interests themselves, additional evidence should be obtained to make that determination.

The Board decided that the method of determining whether embedded derivatives requiring bifurcation exist in beneficial interests should be the same for both purchased interests and interests obtained by transferors. That is, both purchasers and transferors will evaluate whether an embedded derivative requiring bifurcation exists at the level of the interests themselves.

The Board also decided that the fair value measurement option is applicable only to hybrid financial instruments. This decision excludes from the fair value measurement option hybrid instruments that have as their hosts the interests listed in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*.

Objective of Meeting:

The objective of the meeting was to provide guidance on how to evaluate and identify embedded derivatives in beneficial interests in securitized financial assets.

Matters Discussed and Decisions Reached:

1. Mr. E. Smith stated that the first question to ask the Board was what is meant by the phrase *the terms of the interest itself*? He stated that he believes this phrase is meant to refer to the certificate/instrument representing the interest as well as all related documents (such as a prospectus). He stated that the certificate/instrument itself provides limited useful information whereas the prospectus, supplements, pooling and servicing agreements, and other documents normally set out all pertinent rights being obtained (including the cash waterfall that describes rights to cash flows vis a vis all other interest holders). He asked that the Board clarify what is meant by the phrase *the terms of the interest itself*.

2. Mr. E. Smith stated, assuming that the Board agrees that the phrase *the terms of the interest itself* means the certificate/instrument representing the interest and all related documents, that he also recommends that a principal be stated that would clarify the objective of evaluating cash flows. He stated that the objective is to obtain sufficient evidence to identify explicit or implicit embedded derivatives requiring bifurcation. He stated that this principal could state that sufficient evidence may be available in the documents supporting the term of the interest itself; however, if the terms of the interest itself are not conclusive as to the presence of embedded derivatives requiring bifurcation, additional evidence should be obtained. He asked for the Board's approval to include such a principal when describing how cash flows should be evaluated when identifying embedded derivatives.

3. Mr. E. Smith asked if the Board wanted to maintain two levels of cash flow evaluation for purposes of identifying and bifurcating embedded derivatives. He stated that the working proposal that is being used requires that purchasers of interests evaluate cash flows based on the terms of the interest itself; however, the working proposal requires that the transferor's interests be evaluated based on the cash flows of the assets and other contracts present in the transaction. He argued that having two levels of cash flow evaluation is not consistent with the decision to initially measure at fair value transferor's interests. That decision

was based on the conclusion that such interests are new assets to the transferor. The working proposal leads to similar interests potentially being accounted for differently depending on the holder of the interest. Instead, coupled with the principal discussed previously, he recommended that only one level of cash flow evaluation be required for both purchased interests and transferor interests. He asked the Board to determine whether it wishes to maintain the two-level cash flow evaluation requirements.

4. Mr. E. Smith asked whether the fair value option should be available to all hybrid instruments or only to hybrid financial instruments. He stated that he believes that the Board has not deliberated whether fair value is an appropriate measurement attribute for nonfinancial hybrid instruments and recommended that the fair value option be limited to only hybrid financial instruments. He asked for the Board's concurrence with this recommendation.

5. Mr. E. Smith acknowledged that the question regarding the levels at which the cash flows are evaluated does not address concentrations of credit and prepayment risk and whether such concentrations are derivatives or embedded derivatives. He stated that he believes that if cash flows are evaluated based on the terms of the interest itself such concentrations will be identified. He stated that at the next scheduled Board meeting in mid January, the staff intends to address whether such concentrations are derivatives or embedded derivatives.

6. Mr. E. Smith restated the that the principal he recommended was that in identifying embedded derivatives, sufficient information may be available in the documents supporting the terms of the interest itself; however, if the terms of the interest itself are not conclusive as to the presence of embedded derivatives requiring bifurcation, additional information should be obtained.

7. Mr. Batavick questioned where the additional information could be obtained. Mr. E. Smith stated, in general, these will be interests that are held by the transferor, and the transferor will have additional information about the assets. He stated that if it is a purchased interest and sufficient information is not available in the documents, the purchaser would have to seek out more detailed

information from the trustee or seller as to what assets are in the trust. However, Mr. Smith did state that he believed that, in general, sufficient information will be available from the documents.

8. Mr. Trott stated that he agrees with the principal because he thinks that in some cases securitizations are not done in a public forum, and, therefore, the level of detail may not be sufficient. He stated that he believed that in most cases the terms will provide sufficient information, but if for some reason the terms do not, the holder will need to look deeper.

9. Ms. Schipper responded to the question of what is meant by the phrase *the terms of the interest itself*. She stated that she believes that the phrase refers to the type of information that may be obtained from certain documents, not to the documents themselves. She stated that the phrase *the terms of the interest itself* refers to the commercial arrangement that governs the pay-off structure and the subordination status of the instrument, and she stated that this information may be obtained from the certificate, prospectus, indenture, or other documents. All Board members agreed.

10. All Board members agreed to clarify that the objective is to obtain sufficient evidence to determine whether there is an embedded derivative requiring bifurcation in the beneficial interest. If there is not sufficient evidence to make that determination in the terms of the interests themselves, additional evidence should be obtained to make that determination.

11. Mr. E. Smith asked whether the Board wanted to maintain different cash flow evaluation for the purchasers versus the transferor? Ms. Seidman stated that the majority of the Board previously decided to measure retained interests at fair value, rather than an allocated carrying amount, on the basis that they had changed enough to be considered “new.” While she does not personally agree with that earlier decision, she said that the staff recommendation to use a consistent approach for identifying embedded derivatives in both purchased and retained interests would be consistent with that decision. All Board members agreed that the method of determining whether embedded derivatives requiring

bifurcation exist should be the same for both purchased interests and interests obtained by transferors. That is, both purchasers and transferors will evaluate whether an embedded derivative requiring bifurcation exists at the level of the interests themselves.

12. Mr. E. Smith asked whether the fair value option to be provided hybrid instruments containing embedded derivatives requiring bifurcation should apply to all hybrid instruments or only to hybrid financial instruments. All Board members agreed that the fair value option should only apply to hybrid financial instruments. This decision excludes from the fair value measurement option hybrid instruments that have as their hosts the interests listed in paragraph 8 of Statement 107.

Follow-up Items:

None.

General Announcements:

None.