MINUTES

Financial Accounting Standards Board

To: Board Members

From: Derivatives Implementation Team
(Salo, ext. 312)

Subject: Minutes of May 5, 2004 Board Meeting **Date:** May 14, 2004

cc: Bielstein, Smith, Petrone, Polley, Swift, Leisenring, Sutay, Thompson, Gabriele, Intranet, Project Team

Topic:	Derivatives Implementation: Clearance of Statement 133 Implementation Issue No. G25
Basis for Discussion:	Memorandum dated April 9, 2004
Length of Discussion:	1:00 p.m. to 1:50 p.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott
Board members absent:	None
Staff in charge of topic:	Wilkins
Other staff at Board table:	L. Smith, Golden, Laurenzano, Salo
Outside participants:	None

Summary of Decisions Reached:

The Board discussed possible revisions to Implementation Issue No. G25, "Hedging the Variable Interest Payments in a Group of Prime-Rate-Based Interest-Bearing Loans," that would allow entities to use the first-interest-payments-received technique (described in Question 2 of that Implementation Issue) under certain circumstances. The Board directed that the staff analyze the ramifications of those possible revisions and determine the most effective way for Board-directed guidance to be communicated. The staff will prepare a draft of those revisions for discussion at the May 12, 2004 Board meeting.

Objective of the Meeting:

The objective of the meeting was for the Board to decide whether it should (a) simply clear the proposed Implementation Issue G25 to preclude the use of the first-prime-rate-based-interest-payments-received technique when the hedged risk is the risk of overall changes in the hedged cash flows or (b) modify FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* (as amended) to "improve" the application of cash flow hedge accounting to the variability of non-benchmark-interest-rate-based cash flows related to financial assets and liabilities.

Matters Discussed and Decisions Reached:

Ms. Salo began the discussion by giving an overview of the comments received on Implementation Issue G25. She stated that most of the respondents disagreed with the tentative guidance in Implementation Issue G25 because it would cause them to discontinue use of the first-prime-rate-based-interest-payments-received technique, a method that they apparently had been using for several years in cash flow hedges of prime-rate-based loans. She stated that most respondents did not argue that the first-prime-rate-based-interest-payments-received technique is appropriate under Statement 133 (as amended), but disagreed with the outcome of the guidance in Implementation Issue G25 and thus urged that changes be made in Statement 133 (as amended) to permit them to continue their current practices. Ms. Salo stated that the most commonly recommended change was to add the prime rate as an acceptable benchmark rate. Also, she stated that many respondents were reluctant to use the technique presented in Implementation Issue G25 for multiple reasons, including increased volatility in earnings and, in a situation where interest rates move significantly, the old swap may be so deep in the money that it would not be effective in a newly designated hedging relationship.

Mr. Wilkins continued the discussion by describing the staff's proposed alternatives for moving forward. He stated that the Board must decide whether it should (a) clear the proposed Implementation Issue G25 to preclude the use of the first-prime-rate-based-interest-payments-received technique when the hedged risk is the risk of overall changes in the hedged cash flows or (b) modify Statement 133 to “improve” the application of cash flow hedge accounting to the variability of non-benchmark-interest-rate-based cash flows related to financial assets and liabilities. He stated that if the Board decided to clear the proposed guidance, the staff would provide the Board with necessary revisions to the Implementation Issue and an analysis of the third aspect of the tentative guidance in that issue regarding whether or not the hedging entity needs to conclude that the forecasted transaction is probable of occurring, if the entity is, in fact, hedging the risk that the transaction will not occur.

Mr. Wilkins stated that the staff recommends that the Board members agree to modify the cash flow hedging provisions of Statement 133 (as amended) by deleting the prohibition against designating interest rate risk as the hedged risk when the hedged cash flows are explicitly based on an index that cannot qualify as the benchmark rate. He stated that if the Board deletes the prohibition, entities could designate the interest rate risk as the risk being hedged, which would then allow them to use a first-payments-received technique to identify the hedged transactions. He stated that this solution was preferable because it would keep the solution solely in the area of cash flow hedge accounting and would not affect fair value hedge accounting. Mr. Wilkins then opened the discussion for questions.

Mr. Trott stated that he was concerned with the staff recommendation due to what it might do with concern to sector spreads, which was discussed during deliberations on FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, an amendment of FASB Statement No. 133. He stated that when Statement 138 was issued, the Board received input that interest rate risk overall included elements that were very difficult to hedge, which led to the refinement of interest rate risk to the benchmark rate.

Ms. Schipper asked for clarification regarding the staff recommendation. She asked, for example, if under the staff recommendation she could designate the BBB Moody’s interest rate as the interest rate she is hedging against. Mr. Wilkins responded that under the staff recommendation, because it would not redefine interest rate risk, she would still have to select as the hedged risk the risk of changes in a benchmark interest rate (LIBOR or Treasury rate in the United States). Mr. Laurenzano and Mr. Wilkins clarified that under the staff recommendation, the entity could only hedge the change in cash flows attributable to changes in the benchmark rates. They stated that any other changes (changes in cash flow not attributable to changes in the benchmark rate) that occur are considered unhedged risks.

Ms. Schipper also asked whether the staff believed that the staff recommendation was what respondents had in mind when asking for changes to be made to Statement 133. Mr. Wilkins stated that although the majority of respondents indicated a preference for broadening the definition of the benchmark rate, he believed that the staff recommendation addressed the major concern of the respondents, which was the inability to continue the use of the first-payments-received technique under the tentative guidance in Implementation Issue G25.

Mr. Trott questioned if, for example, under the staff recommendation, an entity had a portfolio of prime based loans and obtained a swap based on the prime rate, any ineffectiveness would be recognized. Mr. Wilkins clarified that to the extent that changes in the prime rate is different than changes in the LIBOR rate, there is the potential for ineffectiveness. Mr. Wilkins stated that this was a consequence of redefining interest rate risk under Statement 138. Mr. Herz stated that respondents were focused on the first-payments-received technique. Mr. Wilkins agreed and stated that the staff recommendation was developed to solve this primary concern as most respondents did not believe that the technique included in the tentative guidance was an effective or operational technique.

Ms. Seidman challenged the premise behind the staff recommendation. She believes that it is acceptable to read Statement 133, including its interpretations, to permit the practice that is currently occurring. She believes that the following two items, taken together, have caused this question to arise:

1. Deciding how to treat credit risk in a hedge of overall cash flows.
2. Fall out from the cut that the Board made to redefine interest rate risk under Statement 138.

She believes that under the body of guidance of Statement 133 (as amended), the principle established was that credit risk should be considered in determining whether it is probable that the hedged cash flows will be received even when the hedge is a hedge of the overall change in cash flow. She stated that this principle was established in Implementation Issues G7 and G10, which specifically mention hedges of overall change in cash flows. Therefore, she does not believe that an amendment of Statement 133 is needed to resolve this issue. Also, she stated that she is opposed to amending Statement 133 (as amended) until the project is opened up for convergence purposes. In response, Mr. Wilkins stated that Implementation Issue G7 addresses how you assess ineffectiveness in a cash flow hedge. He stated that the staff's view differs from that of Ms. Seidman, because the staff believes that what constitutes an appropriate designation for the hedging relationship is distinct from both (a) the requirement that the identified hedged forecasted transactions be probable of occurring and (b) the risk that is designated as the hedged risk in documenting that hedging relationship.

Mr. Herz stated that normally in hedging a forecasted transaction, it would have to be probable of occurring, and part of "probable of occurring" is whether or not the payments will be received. Ms. Seidman stated that this designation would be the hedge of changes in the overall cash flows from a contractual coupon on a debt instrument. Mr. Wilkins responded with two comments. He stated that first, the staff did not believe that the probable-of-occurring criterion made sense if you are hedging the risk that the receipts would not occur. This is due to the fact that if you have a derivative that will provide the cash flows if the hedged contractual cash flows do not materialize, then you should not have to meet the test that those hedged contractual cash flows are probable of occurring. Secondly, the staff believes that it is inconsistent to say that you are hedging the risk that certain payments will not be made as contractually required, but then identify the hedged transaction as only those payments that are received. Ms. Seidman stated that if the Board was looking to provide an internally consistent answer, it would apply the same methodology in this situation as in Implementation Issue G13. Mr. Wilkins stated that Implementation Issue G13 only addresses the hedging of interest rate risk and not the risk that the payments will not be made. Ms. Seidman stated that interest rate risk includes prepayment risk, so if overall cash flows include credit risk, what is the difference? Mr. Wilkins stated that in situations in which the hedged payments are the first payments received, not the first contractually due payments, it makes a difference because under Implementation Issue G13, you are not hedging the risk that payments are not made. Ms. Seidman stated that she viewed the situations as parallel as the exact same phenomenon could occur if a portion of the portfolio prepaid and those cash flows evaporated.

Mr. Herz stated that he generally supported the staff recommendation, but he, along with Mr. Trott, did not understand why entities should have to relate a prime-rate-based loan to LIBOR, instead of prime, in order to not have ineffectiveness (on overhedges). Mr. Wilkins stated that it was a consequence of the revisions made in Statement 138. Ms. Seidman stated that at this point the Board should be looking to simplify. Mr. Herz stated that if the Board added a project to its technical agenda, he would at least look to do it convergent with IAS 39.

Mr. Trott stated that although he agreed with the staff's analysis of the issue presented in Implementation Issue G25, as it is consistent with the literature that currently exists, he did not believe that it is the better answer. He preliminarily supported allowing entities to use the first-payments-received technique of identifying the hedged forecasted transactions if the hedged variable interest payments for an interest-bearing financial asset are based on the same rate or index as the underlying for the hedging instrument. He preliminarily supported issuing a Board-directed answer to the Implementation Issue, without considering an immediate amendment of Statement 133 concurrently. Ms. Schipper clarified that Mr. Trott's proposal was to issue Board-directed implementation guidance that states that Ms. Seidman's interpretation (as stated earlier) is acceptable. Mr. Trott clarified that although he did not agree with Ms. Seidman's interpretation of the Statement 133 guidance, he did believe that it may be the better answer if the Board decides it wants to accommodate that outcome. Mr. Wilkins stated that Mr. Trott's proposal would not apply to hedging the interest payments on financial liabilities, but only to financial assets.

Ms. Schipper summarized the proposal by stating that the following modifications would be made to the tentative guidance in Implementation Issue G25:

1. The question and response to Question 1 would remain unchanged.
2. The response to Question 2 would be modified to reflect the Board-directed answer.
3. Question 3 would be dropped from the tentative guidance.

Mr. Herz suggested that the staff analyze the ramifications of those revisions proposed by the Board and determine the most effective way for the Board-directed guidance to be communicated. He stated that the staff should present the revisions and analysis for discussion at the May 12, 2004 Board meeting.

Follow-up Items:

The Board directed the staff to prepare revisions to Implementation Issue G25. The Board directed that the staff analyze the ramifications of those revisions and determine the most effective way for the Board-directed guidance to be communicated. The staff will prepare those revisions and analysis for discussion at the May 12, 2004 Board meeting.

The objective of the meeting was not met. The Board did not make a final decision on the outcome of Implementation Issue G25.

General Announcements:

The QSPE project will be holding two public roundtables. The first public roundtable, attended mainly by attorneys, will be held on May 25, 2004 to discuss the legal issues surrounding the isolation requirement of Statement 140. The second roundtable related to the isolation issues that apply specifically to the regulated financial institutions, attended mainly by regulators and attorneys familiar with regulated financial institutions, will be held on June 17, 2004.