MINUTES

Financial Accounting Standards Board

To: Board Members

From: Salo, ext. 312

Subject: Minutes of May 12, 2004 Board Meeting **Date:** June 4, 2004

cc: Bielstein, Smith, Golden, 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 May 11, 2004
Length of Discussion:	10:05 a.m. to 10:30 a.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 staff revisions to Implementation Issue No. G25, "Hedging the Variable Interest Payments on a Group of Prime-Rate-Based Interest-Bearing Loans." The Board did not object to the staff's recommended revisions to permit the use of the first-payments-received technique when 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 or on (a) a financial institution's prime interest rate, (b) the prime rate published in the *The Wall Street Journal (*WSJ), or (c) the interest rate for "bank prime loan" in the Federal Reserve Statistical Release H-15, "Selected Interest Rates," provided that the underlying for the hedging instrument is also based on one of the aforementioned prime interest rates (even though it is not exactly the same prime interest rate on which the financial asset is based).

Also, the Board unanimously supported recommendations made by Board members to reorganize the format of the Implementation Issue and allow outside review by the Derivatives Implementation Group and other selected constituents before Implementation Issue G25 is finalized.

The Board did not object to the staff's posting of Implementation Issue G25, as revised consistent with Board member recommendations, on the FASB website as cleared guidance after considering the comments received from the outside review.

Objective of the Meeting:

The objective of the meeting was for the Board to decide whether it should clear the proposed revised Implementation Issue G25, which permits a broadened application of the first-payments-received technique in identifying the hedged forecasted transactions in a cash flow hedging relationship even though the hedged risk is the risk of overall changes in the hedged cash flows.

Matters Discussed and Decisions Reached:

Mr. Wilkins began the discussion by giving a brief synopsis of the May 5, 2004 meeting. He stated that during that discussion, Board members tentatively 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, but generally did not support the staff recommendation to amend Statement 133 to eliminate the prohibition that the designated interest rate is the hedged risk when the variable payments are based on a non-benchmark rate or index. He stated that based on the comments received at the May 5, 2004 Board meeting, the staff drafted proposed revisions to Implementation Issue G25.

Mr. Wilkins stated that the staff supports the limited expansion of the application of the first-payments-received technique discussed by the Board at the May 5, 2004 Board meeting, but with one modification. He stated that permitting the use of the first-payments-received technique only when 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 makes sense except when prime interest rates are involved. Because different prime rates (established by different creditors) are in use, the staff believes a special accommodation is warranted. Otherwise, if the variable interest payments were based on the creditor's own prime rate (for example, the lending bank's own prime rate) but the hedging instrument was based on WSJ prime rate, the first-payments-received technique could not be used because those two rates are not the same, causing many banks to be denied any relief with respect to their portfolio of prime-rate-based loans for which they had previously used the first-payments-received technique.

Therefore, Mr. Wilkins stated that the staff proposes permitting the use of the first-payments-received technique when 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 or (a) a financial institution's prime interest rate, (b) the prime rate published in the WSJ, or (c) the interest rate for "bank prime loan" in the Federal Reserve Statistical Release H-15, "Selected Interest Rates," provided that the underlying for the hedging instrument is also based on one of the aforementioned prime interest rates (even though it is not exactly the same prime interest rate on which the financial asset is based). Mr. Wilkins also stated that the Implementation Issue would include a paragraph indicating that the guidance provided was Board-directed.

Mr. Trott stated that he agreed with the staff's recommendation and suggested a few changes to enhance the understandability of Implementation Issue G25. First, he stated that only the first of the two questions currently posed in Implementation Issue G25 should be retained as the question. He suggested phrasing the question as, “Can the first-payments-received approach be used for prime-rate-based interest payments and other non-benchmark interest rates?” He also recommended that the staff enhance the discussion of how ineffectiveness might arise under Implementation Issue G25. He also wanted a statement included that would clearly indicate that the use of first-interest-payments received is a cash flow hedge of the overall cash flows, and a direct hedging of interest rate risk is not possible because these are non-benchmark rates. Ms. Schipper agreed with the staff recommendation and Mr. Trott’s proposed revisions.

Ms. Seidman did not agree with the staff’s proposed revisions for multiple reasons. She believes that the prime rate should not be dealt with in a different manner than any other non-benchmark index. Instead, she believes that Implementation Issue G25 should be revised to reflect that entities can designate the first dollar cash flows in an overall hedge of cash flow, regardless of the index it is based on, as long as it meets all other hedge criteria and effectiveness is assessed with any ineffectiveness recognized. She does not believe that Implementation Issue G25 should go into any detail regarding any particular index. Mr. Wilkins stated that he was under the assumption that the Board was not in favor of offering a blanket dispensation for entities to use the first-payments-received technique. Overall, the Board did not agree with Ms. Seidman’s proposal for a broader exception.

Ms. Seidman stated that Implementation Issue G25 should be phrased in a more principles-based manner so as not to exclude other variations in non-benchmark rates. Ms. Seidman stated that if the Board believes that the first-payments-received technique should be permitted 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, the Board should allow the effectiveness test to sort out any breakage between the variations of prime rate rather than direct the three types of prime that would be included. Ms. Seidman considered different variations of prime and LIBOR to be “based on the same index.” Mr. Wilkins was concerned with Ms. Seidman’s use of the word “same” when he believes she intends “substantially the same.” He stated the word “same” should mean “identically the same.”

Ms. Seidman also commented that she does not believe the slight mismatches in rates due to different variations of rates (for example, between a bank's prime rate and the WSJ prime rate) to be unique to the prime rate; therefore, she recommended that the staff ask constituents if there are any other fact patterns in other non-benchmark rates that the Board should be made aware of before the finalization of Implementation Issue G25. The Board supported her recommendation to receive further information from constituents through a limited exposure of the revised guidance.

Mr. Herz stated that he supported Ms. Seidman's principles-based approach, but at this time, he agreed with the more limited staff's recommendation including Mr. Trott's suggested revisions. He stated that the staff should recirculate Implementation Issue G25 for comments from DIG members and receive further information from constituents as per Ms. Seidman's recommendation. Mr. Batavick suggested that since this issue was of great concern to small financial institutions, whose members are not currently represented in the DIG group, the staff should also distribute drafts to a representative sample of small financial institutions for comment.

In summary, the Board did not object to the staff's proposed revisions and unanimously supported recommendations made by Board members to reorganize the format of Implementation Issue G25 and allow outside review by the DIG and other selected constituents before the Implementation Issue is finalized.

<u>Follow-up Items</u>:

The objective of the meeting was met.

<u>General Announcements</u>:

None.