MINUTES

To: Board Members

From: Derivatives Team (Kramer, ext. 273)

Subject: Minutes of the March 2, 2004 Board Meeting (St. 133, Issue B38) **Date:** March 9, 2005

cc: Bielstein, L. Smith, Golden, Petrone, Leisenring, Wilkins, Lott, E. Smith, Laurenzano, Belcher, Thompson, Gabriele, Sutay, 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.

Topics: Potential Statement 133 Implementation Issue No. B38—Addressing Paragraph 13(b)

Basis for Discussion: Board memorandum dated February 17, 2005.

Length of Discussion: 2:30 p.m. to 3:00 p.m.

Attendance:

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

IASB Board/Staff present: None

Board members absent: None

Staff in charge of topics: Belcher

Other Staff at Board table: L. Smith, Wilkins, Laurenzano, Kramer

Outside Participants: None

Summary of Decisions Reached:

The Board decided to provide an explicit scope exception from the requirements in paragraph 13(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* to embedded call options in a debt instrument if the right to accelerate the settlement of the debt instrument can only be exercised by the borrower (issuer). The staff clarified to the Board that the guidance only applies to embedded call options with respect to the application of paragraph 13(b) of Statement 133 and that such call options are still subject to the requirements in paragraphs 13(a) and 61(d) of Statement 133. In addition, this guidance does not apply to other embedded features that may be present with a call option in the same hybrid instrument.

The exception will take the form of a new Statement 133 Implementation Issue (Issue B39) that the staff will provide to the Statement 133 Resource Group for its comments. The staff will communicate comments received from the Resource Group to the Board at a future meeting, at which time transition and effective date guidance will be discussed, prior to exposing the Implementation Issue for public comment. The staff plans to perform additional research and return to the Board with a recommendation as to whether the Board should proceed with discussions on the original "net settlement" issue addressed in Statement 133 Implementation Issue No. B38, "Evaluation of Net Settlement with Respect to the Settlement of a Debt Instrument Through Exercise of an Embedded Put or Call."

Objective of the Meeting:

The objective of the meeting was to discuss how Statement 133 could be amended or interpreted such that certain common prepayment options in commercial loans would be considered clearly and closely related under paragraph 13(b) and, therefore, would not be affected by the guidance in Implementation Issue B38, as drafted. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Mr. Belcher introduced the issue. At the February 2 Board meeting, the staff was prepared to present to the Board for discussion Statement 133 Implementation Issue B38, which provided guidance as to whether "net settlement" exists with respect to embedded prepayment options in certain debt instruments. If a prepayment option was not considered clearly and closely related to the debt host under paragraph 13(b) of Statement 133 (which the staff observed could be the case in certain circumstances), the guidance in Implementation Issue B38 would have required such options to be bifurcated and accounted for separately as derivatives. Implementation Issue B38 was not discussed at that meeting, because some Board members believed that common prepayment options in commercial loans should *always* be considered clearly and closely related to the debt host, regardless of the guidance in paragraph 13(b) of Statement 133.

2. As a result, the staff was asked to further research how Statement 133 could be amended or interpreted such that certain common prepayment options in commercial loans *would* be considered clearly and closely related under paragraph 13(b) and, therefore, would not be affected by the guidance in Implementation Issue B38, as drafted.

3. To address this concern, the staff has prepared three alternatives for the Board's consideration at this meeting:

   Alternative 1—*Provide an explicit scope exception from the requirements of paragraph 13(b) for hybrid instruments that have certain characteristics of common prepayable commercial loans*

   Alternative 2—*Provide an explicit scope exception from the requirements in paragraph 13(b) to an embedded call option in a debt instrument if the right to accelerate the settlement of the debt instrument can only be exercised by the borrower (issuer)*

   Alternative 3—Make n*o changes to paragraph 13(b).*

4. The staff recommended Alternative 2, the broader scope exception for all call options embedded in debt instruments. In response to a request at the education session, the staff has provided Board members with a new

proposed Statement 133 Implementation Issue patterned after Alternative 2, with examples of how this guidance would be applicable to common embedded call options.

5. Mr. Batavick stated that he believed that it is clear that the Board that issued Statement 133 did not intend for all prepayment arrangements to be subject to the embedded derivatives rules. Bifurcation of these arrangements is not an improvement in financial reporting. The staff is using a practical approach by viewing these instruments from the perspective of the debt issuer. Mr. Batavick supported Alternative 2. He believed that Alternative 1 is too narrow, and Alternative 3 would put too great a burden on preparers when they issue new instruments.

6. Ms. Schipper stated that the issue is complex. The Board that issued Statement 133 did not intend to bifurcate all mechanisms used to accelerate payments, but created a corridor in paragraph 13 to enumerate what is acceptable. Accepting Alternative 2 would be an admission by the Board that the Board that issued Statement 133 did not create this corridor properly. Their intent was that an issuer has to double its rate of return to require bifurcation.

7. Mr. Batavick agreed with Ms. Schipper's statement but stated that common practice within the commercial loan market is to not bifurcate such instruments, and it has been a well accepted practice, even if erroneous.

8. Mr. Wilkins, the project manager for the Statement 133 project, explained the rationale behind the 100 percent corridor. The corridor seemed very reasonable and, at the time, seemed to require a very large change in the rate of return. However, changes in the interest rate environment have made such a corridor narrower. The staff is willing to recommend Alternative 2 considering that the prepayment option is not under the control of the issuer but rather the debtor. The issuer may not stand to gain great benefit from prepayment, despite a doubled rate of return, and does not have the right to exercise such an option. The staff feels that Alternative 2 is superior to Alternative 1 and Alternative 3.

9. Ms. Schipper stated that although she is uncomfortable with Alternative 2, she agreed with it because a senior staff member on the Statement 133 project (Mr. Wilkins) is willing to recommend it.

10. Mr. Trott and Mr. Herz both support the staff recommendation.
11. Mr. Crooch clarified that if all of the specific guidance were stripped away, these arrangements would be bifurcated derivatives. The accounting affects both the issuer and the debtor, and this discussion is not solely about helping issuers.
12. Ms. Seidman supported Alternative 2. If a debt instrument has a leveraged floating rate (such as LIBOR times 4) it will get caught as a second separate embedded derivative. It is important to only exempt only the call option feature from the requirements of paragraph 13(b) and not other embedded derivatives.
13. Mr. Wilkins stated that there are two separate Implementation Issues that will address these issues. Implementation Issue B38 addresses the paragraph 9 net settlement issues, and Implementation Issue B39 addresses the paragraph 13(b) issue regarding the clearly and closely related test.
14. Mr. Belcher stated that the staff will make revisions to the draft Implementation Issue based on discussions at today's meeting and provide a revised draft to the Statement 133 Resource Group for their comments. The staff will communicate comments received from the Resource Group to the Board and present any proposed changes to the Implementation Issue to the Board at a future meeting, at which time transition and effective date guidance will be discussed, prior to exposing the draft Implementation Issue for public comment.

Follow-up Items:

None

General Announcements:

None