

MINUTES



**To:** Board Members  
**From:** Project Team (Cowan, ext. 233)  
**Subject:** Minutes of the October 25, 2006  
Board Meeting: Statement 155      **Date:** October 25, 2006  
Implementation Issues  
**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:** FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, Implementation Issues

**Basis for Discussion:** Memorandums No. 1, dated October 11, 2006 and No. 2, dated October 20, 2006

**Length of Discussion:** 8:00 a.m. to 8:40

**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, Golden, Stoklosa, Wilkins, and Cowan

Outside participants: None

Summary of Decisions Reached:

The Board decided:

1. To include a narrow scope exception for securitized interests that only contain an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets. If a securitized interest contains any other terms that affect some or all of the cash flows or the value of the contract in a manner similar to a derivative instrument, that securitized interest would not meet the narrow scope exception and would therefore be evaluated pursuant to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
2. To have the guidance's effective date prior to the reporting deadline of periods ending December 31, 2006.
3. To address early adoption of Statement 155 in the following ways:
  - a. For entities that early adopted Statement 155 and did not bifurcate embedded prepayment derivatives, no transition provisions will be provided. However, the Board's guidance will specifically address this scenario to ensure that there is no confusion over the possibility of restating prior financial statements.
  - b. For entities that early adopted Statement 155, identified embedded derivatives that would otherwise be included in the proposed scope exception, and elected to measure the entire hybrid instrument at fair value, the Board's guidance shall be applied retrospectively. The company will be provided with the opportunity to elect any appropriate FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, classification as part of that retrospective application. If the company elects a trading classification under Statement 115, no adjustment to the changes in fair value previously recorded in the income statement is required. However, if the company elected a classification of available-for-sale, the retrospective application would result in a reclassification from the income statement to accumulated other comprehensive income.
  - c. For entities that early adopted Statement 155 and did bifurcate embedded derivatives that would otherwise be included in the proposed scope exception, the Board's guidance shall be applied retrospectively. This would result in the reversal of any changes in the fair value of the embedded derivative that were recorded in income during the prior interim period(s). The combined instrument shall be recorded, both initially and subsequently, based on the Statement 115 classification previously elected for the host instrument.

4. To issue the guidance as a Statement 133 Implementation Issue with a 30-day public comment period.

Objective of Meeting:

The objective of the meeting was to address the application of Statement 133 (as amended by Statement 155) to certain asset-backed securities (ABS) that contain embedded call features and for the Board to decide whether to issue proposed guidance for public comment on that topic. The meeting's objective was met.

Matters Discussed and Decisions Reached:

**Background**

1. Mr. Jacobs explained that Statement 155 amended Statement 133 to, among other things, (a) clarify which interest-only strips and principal-only strips are not subject to the requirements of Statement 133 and (b) establish a requirement to evaluate interests in securitized financial assets to identify interests that are either freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. Additionally, Statement 155 amended the comment section of example 6 in Statement 133 Implementation Issue B39, "Embedded Derivatives: Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor."
2. Mr. Jacobs stated that the staff had received a significant number of inquiries related to those amendments. He explained that the inquiries received by the staff had focused on the analysis of interest rate based derivatives, as credit derivatives are generally exempt from the analysis in accordance with paragraph 14B of Statement 133. Mr. Jacobs further explained that constituents had requested that the Board provide guidance on the application of paragraph 13(b) to securitized interests in prepayable financial assets.
3. Mr. Jacobs stated that it is important to note that both the mortgage-backed securities (MBS) and the underlying financial assets (for example,

prepayable mortgage loans) that are the subject of this issue include embedded derivatives. He clarified that the issue being addressed is not whether they contain a derivative, but when the embedded derivative is required to be separately accounted for.

### **Proposed Scope Exception**

4. Mr. Jacobs stated that, to address constituents' concerns, the staff recommends a narrow scope exception for securitized interests that only contain an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets. If a securitized interest contains any other terms that affect some or all of the cash flows or the value of the contract in a manner similar to a derivative instrument, those securitized interests would be subject to the requirements of paragraph 13(b) (for example, an inverse floater).
5. Mr. Jacobs explained that to accomplish the objective of implementing a scope exception that is limited to securitized interests that only contain an embedded derivative tied to the prepayment risk of the underlying prepayable financial assets, the staff recommends the following scope exception:

A securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of Statement 133 if it meets all of the following criteria:

- a. The right to accelerate the settlement of the securitized interest cannot be exercised by the investor
  - b. The underlying financial assets do not contain an embedded derivative that requires bifurcation
  - c. The securitized interest itself does not contain an embedded derivative that requires bifurcation (including an interest rate related derivative), which is not solely related to the reallocation of prepayment risk inherent in the underlying financial assets.
6. Mr. Jacobs noted that the scope exception above is a working draft and will likely be adjusted, but it provides a framework within which the staff intends to write the scope exception.

7. Additionally, Mr. Jacobs explained that the staff acknowledges that this recommendation provides a broad scope exception for prepayment risk analyzed in accordance with paragraph 13(b). However, it does not provide a blanket scope exception for all interest rate risk. He further explained that the staff believes that this is appropriate for the following reasons:
  - a. The staff considered creating an alternative assessment for prepayment related derivatives (instead of using paragraph 13(b)). The options considered included (1) amending paragraph 13(b) to only require an assessment of “reasonable” future interest rate scenarios, (2) amending paragraph 13(b) so that an assumption of 100% prepayment before the next distribution date is not required to be considered, and (3) creating a new, separate test that was specific to prepayment risk in securitized interests. The staff’s conclusion was that the ultimate result of each of these options would likely be that the vast majority of prepayable securitized interests would not include an embedded interest rate derivative that required bifurcation. Therefore, the staff questions whether it is cost-beneficial to require an assessment of all instruments when a scope exception would achieve a similar result. In other words, the staff believes that this approach is a practical solution to the issue.
  - b. The staff believes that some securitized interests contain less prepayment risk than the interest-only and principal-only strips that are provided a scope exception in paragraph 14 of Statement 133. This, combined with the fact that Statement 133 generally considers an embedded call option to be clearly and closely related to the host debt instrument, leads the staff to believe that applying paragraph 13(b) to securitized interests does not provide the preferred approach.
  - c. There is existing literature that addresses the accounting for changes in the expected cash flows of securitized interests that

result from changes in interest rates (including prepayment rates). This literature includes EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, and the relevant other-than-temporary impairment literature. This guidance ensures that significant permanent unrealized losses are not deferred in other comprehensive income.

- d. The scope exception is designed to be limited and not to include all interest rate related derivatives that could be embedded in a securitized interest. This approach is designed to reduce possible structuring opportunities and to ensure that securitized and nonsecuritized interests are accounted for consistently.
8. Mr. Jacobs noted that this proposed scope exception does not apply to paragraph 13(a) or instruments that are subject to the application of the requirements of that paragraph. For example, interest-only strips that do not meet the existing, narrow scope exception in paragraph 14, are generally analyzed under paragraph 13(a), and it is expected that interest-only strips will often meet the requirements of paragraph 13(a) as they "can contractually be settled in such a way that the investor (holder) would not recover substantially all of its initial recorded investment."
9. Mr. Trott stated that he did not agree with the proposed scope exception. He explained that one of the major objectives in Statement 155 was to eliminate the scope exception for securitized interests provided by Statement 133 Implementation Issue No. D1, "Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," so that securitized interests would be evaluated under the provisions of Statement 133 to determine if

embedded derivatives existed that would require separate accounting. Mr. Trott stated that he believed Statement 155 had appropriately achieved its objectives. Further, he explained that the staff's reference to the scope exception for interest-only and principal-only strips as justification for the proposed scope exception is inappropriate since the Board simply decided not to remove an existing scope exception from the original Statement 133 and did not consider the scope exception in paragraph 14 with regard to prepayment risk in its deliberations of Statement 155. Mr. Trott also explained that he did not object to the Board providing an example of the application of paragraph 13(b) to securitized interests in prepayable financial assets, however, he stated that he did not view an example to be necessary.

10. Mr. Batavick explained that he reviewed all of the materials provided by the staff, including several examples and questioned whether he would have made a different decision in the deliberations of Statement 155 had he known the information recently provided by the staff. He stated that he would likely have given a scope exception similar to the staff's recommendation if such were the case. Mr. Batavick also stated that the investor not having the right to accelerate the payment and the cost benefit considerations were also reasons that he supports the staff's recommendation.
11. Mr. Linsmeier stated that it appears the prepayment option that is embedded is clearly and closely related to the debt host. However, he explained that he is concerned with providing a broad exception for prepayment risk and would therefore prefer to develop an alternative way to evaluate prepayment risk. He also indicated that he was troubled by different accounting results depending on whether the security was issued at a discount or a premium. Mr. Linsmeier stated that the test in paragraph 13(b)(1) referred to interest rate scenarios and that he was sympathetic to the difficulty involved in determining prepayment assumptions for the interest rate scenarios considered as part of a paragraph 13(b)(1) analysis.

Mr. Linsmeier stated that he did not prefer the staff's recommendation because it entirely overrides a decision in Statement 155. However, Mr. Linsmeier also stated that he would not object to the staff's recommendation.

12. Ms. Seidman stated that she views paragraph 13(a) and 13(b) as mechanical tests that were developed late in the process of writing Statement 133 to deal with unusual interest rate features (for example, leverage features) that were otherwise meeting the clearly and closely related criteria. She explained that those tests were not intended to be an obstacle to many common and simple features being considered clearly and closely related to the host debt instrument, including prepayment features, which the Board considered as noted in paragraph 305. Ms. Seidman further explained that the Board at the time believed that other GAAP would address prepayment risk.
13. Ms. Seidman stated that Implementation Issue B39 developed a principle by which embedded call options could be evaluated to determine if paragraph 13(b) should be applied. That principal does not require evaluation of the embedded call option under paragraph 13(b) if the right to accelerate payment can only be exercised by the issuer/borrower. Ms. Seidman also noted that Statement 133 Implementation Issue No. A8, "Definition of a Derivative: Asymmetrical Default Provisions," contains a similar notion and concludes there is not an embedded derivative in the case of asymmetrical default provisions for the same reason (that is, it's out of the control of the holder). She stated that it appeared logical to apply the same principal to ABS with regard to prepayment risk. Ms. Seidman stated that she did not believe that applying such a principal to ABS would override Statement 155, especially since, as the staff noted, paragraph 13(a) still applies to securitized interests. She further stated that scoping MBS into paragraph 13(b) was not a reason that she voted for Statement 155. Ms. Seidman stated that Statement 155 was broader than ABS with prepayment risk and that it still accomplishes its objectives, even if prepayment risk is scoped out

of Statement 133. For these reasons, Ms. Seidman stated that she agrees with the staff's recommendation.

14. Mr. Young stated that he prefers that all financial instruments be accounted for at fair value. He also stated that he did not believe Statement 155 was the best way to achieve that objective, especially since it would result in a different treatment for ABS with prepayment risk compared to other securities. He, therefore, supports the staff's recommendation.
15. Mr. Crooch stated that he would not object to the staff's recommendation. He stated that he is concerned that several more issues will be brought to the Board with the intention of getting scope exceptions similar to the one recommended by the staff.
16. Mr. Herz stated that he also supports the staff's recommendation. He explained that he agreed with the reasoning of Ms. Seidman and the analysis described by Mr. Batavick. Mr. Herz stated that the prepayment option should not be bifurcated since it is clearly and closely related to the host debt instrument. He stated that he believes the staff's analysis of interest-only and principal-only strips is relevant and that the second part of the paragraph 13(b) test was intended to catch features like leverage. Mr. Herz explained that he would have preferred a different approach to evaluating ABS, but he believes that doing so would simply result in more rules.
17. The Board voted six (RHH, GJB, GMC, TJL, LFS, and DMY) to one (EWT) in favor of the staff's recommendation for a scope exception.
18. Mr. Trott indicated that he would be providing an alternative view to the staff's recommendation. He also noted that the staff's recommendation applied to more than single-class MBS. Mr. Trott explained that many ABS transactions intentionally change prepayment risk through the allocation of cash flows to various investors in the ABS and therefore the guidance provided in Implementation Issue B39 is not appropriate.

## Transition and Effective Date

19. Mr. Jacobs stated that, assuming that Statement 155 was not early adopted, the earliest effective date was October 1, 2006, for September 30 year-end companies. He noted that those companies have not yet issued financial statements in which Statement 155 was applied. Therefore, if the proposed guidance is issued and effective prior to the reporting deadline for periods ending December 31, 2006, the staff believes that no transition provisions are required for companies that did not early adopt Statement 155. Consequently, the staff recommends the guidance be effective prior to reporting deadlines of periods that end December 31, 2006.
20. Mr. Jacobs also explained that the staff recommends that the Board address early adoption of Statement 155 in the following ways:
  - a. For entities that early adopted Statement 155 and did not bifurcate embedded prepayment derivatives, no transition provisions will be provided. However, the Board's guidance will specifically address this scenario to ensure that there is no confusion over the possibility of restating prior financial statements.
  - b. For entities that early adopted Statement 155, identified embedded derivatives that would otherwise be included in the proposed scope exception, and elected to measure the entire hybrid instrument at fair value, the Board's guidance shall be applied retrospectively. The company will be provided with the opportunity to elect any appropriate Statement 115 classification as part of that retrospective application. If the company elects a trading classification under Statement 115, no adjustment to the changes in fair value previously recorded in the income statement is required. However, if the company elected a classification of available-for-sale, the retrospective application would result in a reclassification from the income statement to accumulated other comprehensive income.
  - c. For entities that early adopted Statement 155 and did bifurcate embedded derivatives that would otherwise be included in the proposed scope exception, the Board's guidance shall be applied retrospectively. This would result in the reversal of any changes in the fair value of the embedded derivative that were recorded in income during the prior period(s). The combined instrument shall be recorded, both initially and subsequently, based on the

Statement 115 classification previously elected for the host instrument.

21. The Board unanimously agreed with the staff's recommendations for an effective date prior to reporting deadlines for periods ending December 31, 2006, and the transition provisions described above.

### **Form of the Guidance**

22. Mr. Jacobs stated that, to avoid confusion, the staff recommends that the Board issue the guidance as a Statement 133 Implementation Issue, since guidance on accounting for derivative instruments is generally contained in Statement 133 or the related Statement 133 Implementation Issues. Additionally, Mr. Jacobs explained that to accelerate the issuance of guidance, the staff also recommends that the Board approve a 30-day comment period for the proposed guidance, which is shorter than the 35-day comment period historically used for Statement 133 Implementation Issues.
23. Mr. Jacobs noted that, based on a 30-day comment period, the staff expects that the Board could analyze the comment letters received and redeliberate this issue in mid-December. He stated that this should allow for the issuance of the final guidance in early 2007, before most reporting deadlines for periods ending December 31, 2006.
24. The Board unanimously agreed with the staff's recommendations to issue the guidance as a Statement 133 Implementation Issue and to have a 30-day comment period.

### Follow-up Items:

None.

### General Announcements:

None.