Statement 133 Implementation Issues
Index of Tentative Guidance
As of June 12, 2009

			Comment **Due Date**
Section C: Scope Exceptions			
Issue C22	Exception Related to Embedded Credit Derivatives	Released 01/09	2/13/09
Section F: Fair Value Hedges			
Issue F9	Hedging a Portion of a Portfolio of Fixed-Rate Loans	Released 01/01	2/23/01

Notice for Recipients
of This Proposed Statement 133 Implementation Issue

This proposed Implementation Issue would amend the accounting and reporting requirements of paragraph 14B of Statement 133 to provide clarifying language to Statement 133 regarding when embedded credit derivative features, including those in collateralized debt obligations (CDOs) and synthetic CDOs, are not considered embedded derivatives subject to potential bifurcation and separate accounting. The objective of this proposed Implementation Issue is to improve financial reporting by resolving some potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraph 14B.

The Board invites individuals and organizations to send written comments on all matters in this proposed Implementation Issue. Comments are requested from those who agree with the provisions of this proposed Implementation Issue as well as from those who do not. Comments are most helpful if they identify the issues to which they relate and clearly explain the issue or question. Those who disagree with the provisions are asked to describe their suggested alternatives, supported by specific reasoning.

Responses from interested parties wishing to comment must be received in writing by Friday, February 13, 2009. Interested parties should submit their comments by email to "director@fasb.org, File Reference: Proposed Issue C22." Those without email may send their comments to "Russell G. Golden, Technical Director, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116, File Reference: Proposed Issue C22." Responses should **not** be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB's website and will be included as part of the public record with other project materials.

Statement 133 Implementation Issue **No. C22**

Title:	Scope Exceptions: Exception Related to Embedded Credit Derivatives
Paragraph references:	12, 14B
Date released:	January 14, 2009
Comment deadline:	February 13, 2009

INTRODUCTION

This proposed Implementation Issue addresses the scope exception for embedded credit derivative features related to the concentration of credit risk in the form of subordination of one financial instrument to another. The question being addressed is how to determine, under paragraph 14B of Statement 133, which embedded credit derivative features, including those in collateralized debt obligations (CDOs) and synthetic CDOs, are considered not to be embedded derivatives that must be analyzed under paragraphs 12 and 13 for potential bifurcation and separate accounting. This proposed Implementation Issue would amend the accounting and reporting standards of paragraph 14B of Statement 133, as indicated below.

STATEMENT 133 IMPLEMENTATION ISSUE GUIDANCE

Paragraph 14B

1. The embedded credit derivative feature related only to the concentration of credit risk in the form of subordination of one financial instrument to another shall not be considered an embedded derivative that is subject to the application of paragraphs 12, 13, and 14A. Thus, those embedded credit derivative features do not need to be analyzed under those paragraphs for potential bifurcation from the host contract and separate accounting as a derivative.

2. Other embedded credit derivative features, including those in some CDOs and synthetic CDOs, are considered embedded derivatives subject to the application of paragraphs 12, 13, and 14A (including analysis of whether the economic characteristics and risks of the embedded credit derivative features are clearly and closely related to the economic characteristics and risks of the host contract), provided that the overall contract is not a derivative in its entirety under paragraph 6.

AMENDMENTS TO STATEMENT 133

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* is amended as follows: [Added text is <u>underlined</u> and deleted text is ~~struck out~~.]

Paragraph 14B:

~~Changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative contracts) that represent the assets or liabilities that are held by the issuing entity shall not be considered an embedded derivative under this Statement.~~ The concentration of credit risk in the form only of subordination of one financial instrument to another shall not be considered an embedded derivative subject to the application of paragraphs 12, 13, and 14A of ~~under~~ this Statement.

Paragraph 200A:

Example 35: A Dollar-Denominated Floating-Rate Interest Issued by an SPE That Holds Yen-Denominated Floating-Rate Bonds and a Matching Cross-Currency Swap to Pay Yen and Receive Dollars. If the floating rate reflects a current market rate and the notional amounts of the bonds and the swap correspond to the notional amount of the interests issued, ~~the dollar-denominated floating-rate interest would *not* have~~ the bifurcation of an embedded derivative would not be required under paragraphs 12, 13, and 14A because the economic characteristics and risks of any perceived embedded derivative feature would be clearly and closely related to the economic characteristics and risks of the host contract ~~requiring bifurcation because the terms of the beneficial interest do not indicate an embedded derivative and the financial instruments held by the entity provide the necessary cash flows~~.

Paragraph 200B:

Example 36: A Variable-Rate Interest Issued by an SPE That Holds Fixed-Rate Bonds and a Matching Pay-Fixed, Receive-Variable Interest Rate Swap. The variable-rate interest would *not* have an embedded derivative requiring bifurcation under paragraphs 12, 13, and 14A because the economic characteristics and risks of any perceived embedded derivative feature would be clearly and closely related to the economic characteristics and risks of the host contract ~~because the terms of the beneficial interest do not indicate an embedded derivative and the financial instruments held by the entity provide the necessary cash flows~~. However, if the notional amounts of the fixed-rate bonds and the variable interest rate swap do not match (thereby creating the possibility that the financial instruments held by the SPE might not provide the necessary cash flows to the swap counterparty), the variable-rate interest provisions would have to be evaluated for an embedded derivative under paragraph 13 because the underlying is an interest rate or interest rate index ~~financial instruments held by the entity might not provide the necessary cash flows~~.

Paragraph 200D:

Example 38: A Securitization That Introduces New Credit Risk. An SPE ~~entity~~ holds a credit derivative referenced to Company A and high-quality bonds, but issues beneficial interests explicitly referenced to Company B (thus, the cash flows relating to changes in the credit risk of Company B are not present in the financial instruments held by the SPE). The beneficial interests would be a hybrid financial instrument with an embedded derivative subject to the application of paragraphs 12, 13, and 14A because the embedded credit derivative feature referenced to Company B is not based only on the concentration of credit risk in the form of subordination of one financial instrument to another and because the financial instruments held by the SPE might not provide the necessary cash flows related to the embedded credit derivative feature referenced to Company B ~~the cash flows relating to changes in the credit risk of Company B are not present in the financial instruments held by the entity~~.

Paragraph 200E is added as follows:

Example 39: Partially Funded Synthetic CDO. An SPE that holds GICs and that wrote a credit default swap on a referenced credit to a third party, with a significantly larger notional amount than the GICs, issues various tranches of credit-linked beneficial interests to investors that differ in terms of priority and in their potential obligation to fund any losses on the credit default swap. That is, if credit losses greater than the value of the GICs are incurred under the credit default swap, the investors in one or more tranches may be required to provide additional funds to the special purpose entity, which would then be passed on as payments to the holder of the credit default swap. Under paragraph 14B (as revised), the investor's embedded credit derivative feature that relates only to the concentration of credit risk in the form of subordination of one tranche to another is not an embedded derivative subject to the application of paragraphs 12, 13, and 14A of Statement 133. However, the tranches that expose the investor to making potential payments related to defaults on the written credit default swap would contain an embedded derivative subject to the application of paragraphs 12, 13, and 14A (provided that the investor's overall contract is not a derivative in its entirety under paragraph 6 of Statement 133). While the risk in those tranches is credit-related, the investor can lose more than its original investment. Therefore, the credit risk is not related only to subordination and must be evaluated under paragraphs 12, 13, and 14A. Because the credit default swap relates to a referenced credit and could expose the investor to potential payments (not merely reduced cash inflows), the swap's credit risk is not related to the risk of simply failing to receive cash inflows from the referenced credit; thus, the economic characteristics and risks of the credit default swap would not be clearly and closely related to the economic characteristics and risks of the host contract.

Paragraph 200F is added as follows:

Example 40: Fully Funded Synthetic CDO. An SPE that holds U.S. Treasury securities and that wrote a credit default swap on a referenced credit to a third party, with a smaller notional amount than the U.S. Treasury securities, issues various tranches of credit-linked beneficial interests to investors that differ in terms of priority for the distribution of cash flows from the SPE. The assets in the SPE are sufficient to fund any losses on the credit default swap. Thus, none of the tranches expose the investor to potential future payments related to defaults on the written credit default swap; the investor cannot lose more than its original investment. Rather, the investor is exposed to a potential reduction in its future cash inflows, which is the effect of the credit-related risk. That reduction in future cash flows is allocated among the tranches by the subordination of one tranche to another. Under paragraph 14B (as revised), the investor's embedded credit derivative feature is not an embedded derivative subject to the application of paragraphs 12, 13, and 14A of Statement 133 because it relates only to the concentration of credit risk in the form of subordination of one tranche to another.

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after December 15, 2008.

At the date of adoption for the implementation guidance in this Issue, an entity shall assess each preexisting contract that was acquired or issued on or after the date of the reporting entity's adoption of FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, to determine whether any contract contains one or more embedded credit derivatives that, under the revised paragraph 14B, would no longer qualify for the scope exception in that paragraph. The provisions of paragraphs 12, 13, and 14A shall be applied to such contracts at the date of adoption of this Issue to determine whether the embedded credit derivative is required to be separated from the host contract and accounted for separately. However, if a contract (that is, hybrid instrument) would be required to be separated into a host contract and a derivative instrument and if the contract is a hybrid financial instrument, the entity may irrevocably elect to initially and subsequently measure that contract in its entirety at fair value (with changes in fair value recognized in earnings). The fair value election shall be determined on an instrument-by-instrument basis and supported by documentation completed by the end of the fiscal quarter of initial adoption. If the fair value election is not elected for a hybrid contract that is required to be separated into a host contract and a derivative instrument under the revised paragraph 14B, the carrying amount of the host contract at adoption of this Issue would be based upon a pro forma bifurcation as of the inception of the hybrid contract and the host contract's subsequent accounting to the date of adoption.

At adoption, any difference between the total carrying amount of the individual components of the existing bifurcated hybrid instrument and the carrying amount of the combined hybrid instrument prior to bifurcation should be recognized as a cumulative-effect adjustment to beginning retained earnings for the period of adoption. An entity should separately disclose the gross gains and losses that make up the cumulative-effect adjustment, determined on an instrument-by-instrument basis. Prior periods should not be restated.

BASIS FOR CONCLUSIONS

Following a December 11, 2008 administrative meeting, the Board Chairman decided to add a project to the FASB's technical agenda that would provide clarifying language to Statement 133 regarding when embedded credit derivative features, including those in CDOs and synthetic CDOs, are not considered embedded derivatives subject to potential bifurcation and separate accounting. The objective of this Implementation Issue is to improve financial reporting by resolving some potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraph 14B.

Need for Guidance

Questions have arisen in practice about the intended breadth of the embedded credit derivative scope exception in paragraph 14B. It is clear that the concentration of credit risk in the form only of subordination of one financial instrument to another shall not be considered an embedded derivative under Statement 133 and, thus, not be subject to potential bifurcation and separate accounting under paragraphs 12, 13, and 14A. There is some ambiguity in practice about what is meant by the first sentence in paragraph 14B and whether other embedded credit derivative features, including those in some CDOs and synthetic CDOs, are considered not to be embedded derivatives subject to the application of paragraphs 12, 13, and 14A of Statement 133.

In particular, Board members were concerned about the application of the scope exception in paragraph 14B to all embedded credit derivatives, even to embedded credit derivative features (such as a credit default swap on unrelated public company debt) that are not clearly and closely related to the host contract. That broad application of the scope exception for embedded credit derivatives exceeds what was intended by Board members and is not supported in Statement 155's basis for conclusions, paragraphs A21–A24. Consequently, the Board decided to amend paragraph 14B and to provide the guidance in this Implementation Issue. The Board emphasized that credit risk that is not related only to the subordination of one financial instrument to another must be evaluated under paragraphs 12, 13, and 14A.

The Board also realizes that the application of the scope exception in paragraph 14B is not a relevant issue for some synthetic CDOs (such as certain interests in an unfunded synthetic CDO) because the contract may meet the definition of derivative in its entirety. The embedded derivative provisions of paragraphs 12, 13, and 14A do not apply to a contract that meets the definition of a derivative in its entirety.

Statement 133 Implementation Issue **No. F9**

Title:	Fair Value Hedges: Hedging a Portion of a Portfolio of Fixed-Rate Loans
Paragraph references:	21, 432
Date released:	January 2001

QUESTIONS

1. If an entity wishes to hedge its exposure to changes in the fair value of only the right to receive repayment of principal (and not the fair value of the interest payments) for a portfolio of fixed-rate loans that *are not* prepayable, may the entity designate a percentage (for example, 60 percent) of the contractually required principal repayment as the hedged item in a fair value hedge in accordance with paragraph 21(a)(2)(b) of Statement 133?
2. If an entity wishes to hedge its exposure to changes in the fair value of only the right to receive repayment of principal (and not the fair value of the interest payments) for a portfolio of fixed-rate loans that *are* prepayable, may the entity designate a percentage (to be determined retrospectively) of the contractually required principal repayment as the hedged item in a fair value hedge in accordance with paragraph 21(a)(2)(b) of Statement 133? (Note that this percentage would be adjusted retrospectively at each assessment date to result in a hedge of an identical amount of principal for each assessment period over the term of the loans.)
3. If an entity wishes to hedge its exposure to changes in the fair value of its right to receive both all remaining interest payments and the repayment of principal for a portfolio of fixed-rate loans that *are* prepayable, may the entity designate a percentage (to be determined retrospectively) of the original loan portfolio principal balance, bearing interest at a fixed rate until the balloon repayment date, as the hedged item in a fair value hedge in accordance with paragraph 21(a)(2)(a) of Statement 133? (Note that this percentage would be adjusted retrospectively at each assessment date to result in a hedge of an identical amount of principal, bearing interest at the loans' contractual rate, for each assessment period over the term of the loans)?

BACKGROUND

An entity holds a portfolio of fixed-rate loans that contractually require repayment of the original principal balance ($100 million) 5 years from the date of origination. The changes in fair values (both overall and attributable to changes in the benchmark interest rate) of loans that are not prepaid can be expected to move proportionately with each other and with the portfolio as a whole. Assume for purposes of this Issue that all of the other criteria in paragraph 21(a)(1) of Statement 133 have been met (including the aggregation criteria). Therefore, the entity concludes the portfolio of loans (which all mature on the same date) meets the criteria for portfolio hedging in paragraph 21(a)(1) of Statement 133.

The entity wishes to reduce its fair value exposure for $60 million of the total principal repayment of the loan portfolio at maturity. Paragraph 21(a)(2) of Statement 133 specifies the criteria for hedging a portion of an asset or liability or a portion of a portfolio of similar assets and liabilities. It requires the hedged item to be (a) a percentage of the entire asset or liability or of the entire portfolio, (b) one or more selected contractual cash flows of the asset or liability or portfolio, (c) a put option, a call option, an interest rate cap, or an interest rate floor embedded in an existing asset or liability that is not an embedded derivative accounted for separately under the provisions of paragraph 12, or (d) the residual value in a lessor's net investment in a direct financing or sales-type lease. Paragraph 432 states that if an entity hedges a specified portion of a portfolio of similar assets or similar liabilities, "that portion should relate to every item in the portfolio. If an entity wishes to hedge only certain items in a portfolio, it should first identify a smaller portfolio of only the items to be hedged."

For questions 2 and 3, assume the loans in the portfolio, which *are* prepayable, have similar expected prepayment performance. Based on historical experience, the entity estimates that some of the loans will be prepaid either in full or in part. The entity is unable to determine, however, which specific loans will be prepaid. The entity estimates that at least 60 percent of the original portfolio principal balance of $100 million will remain outstanding until the contractual repayment date of the loans in the portfolio.

RESPONSE

<u>Question 1</u>

Yes. An entity may designate as the hedged item a percentage of a selected contractual cash flow (such as the repayment of principal at maturity), even though paragraph 21(a)(2) of Statement 133 makes reference to the hedged item being "a percentage" only in subparagraph 21(a)(2)(a), which relates to the entire recognized asset or liability (or entire portfolio), and not in subparagraph 21(a)(2)(b), which relates to one or more selected contractual cash flows. By indicating that the hedged item in a fair value hedge may be one or more selected contractual cash flows, paragraph 21(a)(2)(b) permits a company to hedge one or more individual contractual payments of the loans in the portfolio. The derivative selected as the hedging instrument must be highly effective at offsetting changes in fair value of the group of selected individual cash flows designated as being hedged. If the loans meet the criteria in paragraph 21(a)(1) of Statement 133 for portfolio hedging, it is reasonable to conclude that a percentage of each of those selected individual cash flows will reflect fair value changes that are proportionate to the fair value changes of the entire group of selected individual cash flows. Assuming the derivative selected as the hedging instrument would be highly effective at offsetting changes in the fair value of the selected individual cash flows (provided the notional amount of the derivative was sufficient), there would be a basis for expecting that the change in that derivative's fair value (with a proportionately reduced notional amount) would be highly effective in offsetting the change in fair value of the designated percentage of each of those selected individual cash flows.

<u>Questions 2 and 3</u>

No. An entity may not designate a percentage (to be determined retrospectively at periodic dates) of either the original loan portfolio principal balance or of the contractually required principal repayment as the hedged item in a fair value hedge in accordance with paragraph 21(a)(2) of Statement 133 to result in a hedge of an identical amount of principal for each assessment period over the term of the loans. Since the entity cannot determine which loans will prepay, it cannot reduce the portfolio to a smaller subset (of loans that will not have been prepaid at the end of the five-year period) as required by paragraph 432 of Statement 133. As a result, it cannot specify a hedged item that consists of a specified portion of every loan in the portfolio and therefore cannot satisfy the requirements of paragraph 21(a)(2). Statement 133 distinguishes between fair value and cash flow hedges with respect to prepayment activity since paragraph 21(f) specifically requires that an entity consider the effect of an embedded prepayment option in designating a fair value hedge of interest rate risk. The corresponding paragraph discussing the requirements surrounding hedging individual risks in a cash flow hedge (that is, paragraph 29(h), which addresses bifurcation by risk) does not contain a comparable discussion about considering the effect of prepayments in a cash flow hedge. Along the same lines, paragraph 21(a)(1) contains a specific condition that when hedging a portfolio of similar assets or liabilities under a fair value hedge, the prepayment history and expected prepayment performance in varying interest rate scenarios must be similar. The corresponding paragraph discussing the requirements for hedging groups of forecasted transactions under a cash flow hedge (paragraph 29(a)) does not contain any discussion about prepayment activity.

The guidance in those paragraphs reflects the fundamental difference that prepayment activity has on a fair value hedge as compared to a cash flow hedge. A typical prepayment option can have a significant impact on the fair value of a fixed-rate financial instrument whereas it does not generally have much impact on the cash flows from a floating rate financial instrument (since there is no significant economic difference, and impact on cash flows, between repricing due to interest rate reset or due to return of principal and reinvestment at the then-current floating rate). Hedge accounting under the scenarios in Questions 2 and 3 would result in circumvention of the requirement in paragraphs 21(a)(1) and 21(f) to consider prepayment risk in a fair value hedge of interest rate risk.

Prepayment risk is integrally related to the change in fair value of the loans due to changes in the benchmark interest rate. Fair value hedge accounting for $60 million of the portfolio using, for example, a plain-vanilla interest rate swap could only be accomplished by erroneously assuming that the prepayment option has been eliminated for that portion of the portfolio. However, if an entity can obtain a hedging instrument with fair value characteristics that can be expected to result in fair value changes for the hedging instrument that offset those of the loan portfolio (such as an interest rate swap with an embedded call provision that is a mirror image of the prepayment option embedded in the loans in the portfolio), that hedging relationship could meet the Statement 133 criteria for fair value hedge accounting.

The above response represents a tentative conclusion. The status of the guidance herein will remain tentative until it is formally cleared by the FASB and incorporated in an FASB staff implementation guide. Constituents should send their comments, if any, to James J. Leisenring, Derivatives Implementation Group Chairman, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116 (or by e-mail to derivatives@fasb.org) by February 23, 2001.