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ACCOUNTING STANDARDS UPDATE

No. 2010-11
March 2010

Derivatives and Hedging (Topic 815)

Scope Exception Related to Embedded Credit Derivatives

An Amendment of the *FASB Accounting Standards Codification*™

Financial Accounting Standards Board
of the Financial Accounting Foundation

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

Questions have arisen in practice about the intended breadth of the embedded credit derivative scope exception in paragraphs 815-15-15-8 through 15-9 of the *FASB Accounting Standards Codification*™. It is clear that the transfer of credit risk that is only in the form of subordination of one financial instrument to another (thereby redistributing credit risk) is an embedded derivative feature that should not be subject to potential bifurcation and separate accounting under paragraph 815-10-15-11 and Section 815-15-25. There is some ambiguity in practice about what paragraph 815-15-15-8 means and whether other embedded credit derivative features, including those in some collateralized debt obligations and synthetic collateralized debt obligations, are subject to the application of paragraph 815-10-15-11 and Section 815-15-25.

Who Is Affected by the Amendments in This Update?

All entities that enter into contracts containing an embedded credit derivative feature related to the transfer of credit risk that is not only in the form of subordination of one financial instrument to another will be affected by the amendments in this Update because the amendments clarify that the embedded credit derivative scope exception in paragraphs 815-15-15-8 through 15-9 does not apply to such contracts.

What Are the Main Provisions?

This Update provides amendments to Subtopic 815-15, Derivatives and Hedging—Embedded Derivatives, as follows:

1. Subtopic 815-15 is amended to clarify the scope exception under paragraphs 815-15-15-8 through 15-9 for embedded credit derivative features related to the transfer of credit risk in the form of subordination of one financial instrument to another. The amendments address how to determine which embedded credit derivative features, including those in collateralized debt obligations and synthetic collateralized debt obligations, are considered to be embedded derivatives that should not be analyzed under Section 815-15-25 for potential bifurcation and separate accounting.
2. The embedded credit derivative feature related to the transfer of credit risk that is only in the form of subordination of one financial instrument

to another is not subject to the application of Section 815-15-25. Thus, only the embedded credit derivative feature between the financial instruments created by subordination is not subject to the application of Section 815-15-25 and should not be analyzed under that Section for potential bifurcation from the host contract and separate accounting as a derivative. Consequently, the following circumstances (among others) do not qualify for the scope exception and are subject to the application of paragraph 815-10-15-11 and Section 815-15-25 for potential bifurcation:

a. An embedded derivative feature relating to another type of risk (including another type of credit risk) is present in the securitized financial instruments.
b. The holder of an interest in a tranche of securitized financial instruments is exposed to the possibility (however remote) of being required to make potential future payments (not merely receive reduced cash inflows) because the possibility of those future payments is not created by subordination.
c. The holder owns an interest in a single-tranche securitization vehicle; therefore, the subordination of one tranche to another is not relevant.

3. Other embedded credit derivative features, including those in some collateralized debt obligations and synthetic collateralized debt obligations, are considered embedded derivatives subject to the application of Section 815-15-25 (which involves an 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 Section 815-10-15.
4. The economic characteristics and risks of an embedded credit derivative feature that is in a beneficial interest in a securitized financial asset and that exposes the holder of an interest in a tranche of that securitized financial instrument to the possibility (however remote) of being required to make potential future payments (not merely receive reduced cash inflows) should be considered to be not clearly and closely related to the economic characteristics and risks of the host contract and thus to meet the criterion in paragraph 815-15-25-1(a).
5. In initially adopting the amendments in this Update, an entity may elect the fair value option for any investment in a beneficial interest in a securitized financial asset; that is, the entity may irrevocably elect to measure that investment in its entirety at fair value (with changes in fair value recognized in earnings). The election of the fair value option should be determined on an instrument-by-instrument basis at the beginning of the fiscal quarter of initial adoption. An entity must ensure

that an impairment analysis of the investment has been performed before the initial adoption of the amendments in this Update.

How Do the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

The Board has provided the clarifications and related additional examples to improve financial reporting by resolving potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraphs 815-15-15-8 through 15-9.

When Will the Amendments Be Effective?

The amendments in this Update are effective for each reporting entity at the beginning of its first fiscal quarter beginning after June 15, 2010. Early adoption is permitted at the beginning of each entity's first fiscal quarter beginning after issuance of this Update.

How Do the Provisions Compare with International Financial Reporting Standards (IFRS)?

IFRS does not contain an embedded credit derivative scope exception comparable to the scope exception in paragraphs 815-15-15-8 through 15-9. Because the amendments in this Update narrow the breadth of the embedded credit derivative scope exception in those paragraphs, the change moves GAAP closer to converging with IFRS.

Amendments to the *FASB Accounting Standards Codification*™

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–12. In some cases, not only are the amended paragraphs shown but also the preceding and following paragraphs are shown to put the change in context. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Subtopic 815

2. Amend paragraph 815-10-50-4K, with a link to transition paragraph 815-10-65-5, as follows:

Derivatives and Hedging—Overall

Disclosure

815-10-50-4K A seller of **credit derivatives** shall disclose information about its credit derivatives and hybrid instruments (for example, a credit-linked note) that have **{glossary link}embedded credit derivatives{glossary link}** ~~(for example, a credit-linked note)~~ to enable users of financial statements to assess their potential effect on its financial position, financial performance, and cash flows. Specifically, for each statement of financial position presented, the seller of a credit derivative shall disclose all of the following information for each credit derivative, or each group of similar credit derivatives, even if the likelihood of the seller's having to make any payments under the credit derivative is remote:

- a. The nature of the credit derivative, including all of the following:
  1. The approximate term of the credit derivative
  2. The reason(s) for entering into the credit derivative
  3. The events or circumstances that would require the seller to perform under the credit derivative
  4. The current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the credit derivative, which could be based on either recently issued external credit ratings or current internal groupings used by the seller to manage its risk

5. If the entity uses internal groupings for purposes of item (a)(4), how those groupings are determined and used for managing risk.

b. All of the following information about the maximum potential amount of future payments under the credit derivative:
   1. The maximum potential amount of future payments (undiscounted) that the seller could be required to make under the credit derivative, which shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the credit derivative (which are addressed in items (c) through (f))
   2. The fact that~~If~~ the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, if applicable~~that fact~~
   3. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the reasons why it cannot estimate the maximum potential amount.

c. The fair value of the credit derivative as of the date of the statement of financial position

d. The nature of any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative

e. The nature of any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the credit derivative, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative

f. If estimable, the approximate extent to which the proceeds from liquidation of assets held either as collateral or by third parties would be expected to cover the maximum potential amount of future payments under the credit derivative. In its estimate of potential recoveries, the seller of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

However, the disclosures required by this paragraph do not apply to an embedded derivative feature related to the transfer of credit risk that is only in the form of subordination of one financial instrument to another, as described in paragraph 815-15-15-9.

3. Supersede paragraph 815-15-15-8, with a link to transition paragraph 815-10-65-5, as follows:

Derivatives and Hedging—Embedded Derivatives

Scope and Scope Exceptions

> > Features Involving Certain Aspects of Credit Risk

815-15-15-8 ~~Changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative instruments) that represent the assets or liabilities that are held by the issuing entity shall not be considered an embedded derivative under this Subtopic.~~Paragraph superseded by Accounting Standards Update 2010-11.

4. Amend paragraph 815-15-15-9, with a link to transition paragraph 815-10-65-5, as follows:

815-15-15-9 The ~~concentration~~ transfer of **credit risk** that is only in the form of subordination of one financial instrument to another (such as the subordination of one beneficial interest to another tranche of a securitization, thereby redistributing credit risk) ~~shall not be considered~~ is an embedded derivative feature that shall not be subject to the application of paragraph 815-10-15-11 and Section 815-15-25~~under this Subtopic~~. Only the **embedded credit derivative** feature created by subordination between the financial instruments is not subject to the application of paragraph 815-10-15-11 and Section 815-15-25. However, other embedded credit derivative features (for example, those related to credit default swaps on a referenced credit) would be subject to the application of paragraph 815-10-15-11 and Section 815-15-25 even if their effects are allocated to interests in tranches of securitized financial instruments in accordance with those subordination provisions. Consequently, the following circumstances (among others) would not qualify for the scope exception and are subject to the application of paragraph 815-10-15-11 and Section 815-15-25 for potential bifurcation:

a. An embedded derivative feature relating to another type of risk (including another type of credit risk) is present in the securitized financial instruments.
b. The holder of an interest in a tranche of that securitized financial instrument is exposed to the possibility (however remote) of being required to make potential future payments (not merely receive reduced cash inflows) because the possibility of those future payments is not created by subordination. (Note, however, that the securitized financial instrument may involve other tranches that are not exposed to potential future payments and, thus, those other tranches might qualify for the scope exception.)

c. The holder owns an interest in a single-tranche securitization vehicle; therefore, the subordination of one tranche to another is not relevant.

5. Amend the heading preceding paragraph 815-15-25-16, with no link to a transition paragraph, as follows:

Recognition

> Applying the Clearly-and-Closely-Related ~~Clearly and Closely Related~~ Criterion

815-15-25-16 If the host contract encompasses a residual interest in an entity, then its economic characteristics and risks shall be considered that of an equity instrument and an embedded derivative would need to possess principally equity characteristics (related to the same entity) to be considered clearly and closely related to the host contract. However, most commonly, a financial instrument host contract will not embody a claim to the residual interest in an entity and, thus, the economic characteristics and risks of the host contract shall be considered that of a debt instrument.

6. Amend paragraph 815-15-25-18, with a link to transition paragraph 815-10-65-5, as follows:

815-15-25-18 The following guidance is relevant in deciding whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. The guidance is organized as follows:

a. Purchase contracts—price cap and price floor
b. Host contracts with equity characteristics
c. Host contracts that are leases
d. Host contracts with debt ~~characteristics.~~ characteristics
e. Hybrid instruments that are beneficial interests in securitized financial assets.

7. Amend paragraph 815-15-25-47, with a link to transition paragraph 815-10-65-5, as follows:

815-15-25-47 If an instrument incorporates a credit risk exposure that is different from the risk exposure arising from the creditworthiness of the obligor under that instrument, such that the value of the instrument is affected by an event of default or a change in creditworthiness of a third party (that is, an entity that is not the obligor), then the economic characteristics and risks of the **{glossary link}embedded credit derivative{glossary link}** are not clearly and closely related to the economic characteristics and risks of the host contract, even though the obligor may own securities issued by that third party. This guidance shall be applied to all other arrangements that incorporate credit risk exposures that are unrelated or only partially related to the creditworthiness of the issuer of that instrument. This guidance does not affect the accounting for a nonrecourse debt arrangement (that is, a debt arrangement in which, in the event that the debtor does not make the payments due under the loan, the creditor has recourse solely to the specified property pledged as collateral).

8. Add paragraph 815-15-25-51A and its related heading, with a link to transition paragraph 815-10-65-5, as follows:

<u>> > Hybrid Instruments That Are Beneficial Interests in Securitized Financial Assets</u>

<u>**815-15-25-51A** An embedded derivative feature that exposes the holder of a beneficial interest in a tranche of a securitized financial instrument to the possibility (however remote) of being required to make potential future payments (not merely receive reduced cash inflows) shall be considered to be not clearly and closely related to the economic characteristics and risks of the host contract and, thus, meet the criterion in paragraph 815-15-25-1(a).</u>

9. Amend paragraph 815-15-55-104, with a link to transition paragraph 815-10-65-5, as follows:

815-15-55-104 The credit-linked note includes an **{glossary link}embedded credit derivative{glossary link}**. The **credit risk** exposure of the reference security (Entity X) and the risk exposure arising from the creditworthiness of the obligor (Entity A) are not clearly and closely related. Thus, the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the debt host contract and, accordingly, the criterion in paragraph 815-15-25-1(a) is met.

10. Amend paragraphs 815-15-55-165 through 55-166, 815-15-55-169, and 815-15-55-224 through 55-226 and their related headings, with a link to transition paragraph 815-10-65-5, as follows:

Implementation Guidance and Illustrations

> > Example 13: Applying the Bifurcation Criteria

815-15-55-165 The following Cases illustrate the application of the guidance in this Subtopic to instruments that contain a variety of embedded derivatives:

a. Inverse floater (Case A)
b. Levered inverse floater (Case B)
c. Delevered floater (Case C)
d. Range floater (Case D)
e. Ratchet floater (Case E)
f. Fixed-to-variable note (Case F)
g. Indexed amortizing note (Case G)

h. Equity-indexed note (Case H)
i. Variable principal redemption bond (Case I)
j. Crude oil knock-in note (Case J)
k. Gold-linked bull note (Case K)
l. Step-up bond (Case L)
m. Credit-sensitive bond (Case M)
n. Inflation bond (Case N)
o. Disaster bond (Case O)
p. Specific equity-linked bond (Case P)
q. Dual currency bond (Case Q)
r. Short-term loan with a foreign currency option (Case R)
s. Lease payment in foreign currency (Case S)
t. Certain purchases in a foreign currency (Case T)
u. Convertible debt (Case U)
v. Dollar-denominated variable-rate interest issued by a special-purpose entity that holds yen-denominated variable-rate bonds and a cross-currency swap (Case V)
w. Variable-rate interest issued by a special-purpose entity that holds fixed-rate bonds and a pay-fixed, receive-variable interest rate swap (Case W)
x. Securitization involving subordination and variable-rate tranches (Case X)
y. Securitization involving subordination and fixed-rate tranches ~~Securitization that introduces new credit risk.~~ (Case Y)
z. Partially funded synthetic collateralized debt obligation with multiple tranches (Case Z)
aa. Fully funded synthetic collateralized debt obligation with multiple tranches (Case AA)
ab. Fully funded synthetic collateralized debt obligation with a single-tranche structure (Case AB).

815-15-55-166 Cases A through AB ~~X~~ illustrate how the guidance in this Subtopic would be applied to contracts with the described terms. If the terms of a contract are different from the described terms, the application of this Subtopic by either party to the contract may be affected. Furthermore, if any contract of the types discussed in Cases A through AB ~~X~~ meets the definition of a derivative instrument in its entirety under paragraphs 815-10-15-83 through 15-139, the guidance for the application of the provisions of this Subtopic to embedded derivatives does not apply.

815-15-55-169 Unless otherwise stated, Cases A through AB ~~Y~~ share both of the following assumptions:

a. If the embedded derivative and host portions of the contract are not clearly and closely related, a separate instrument with the same terms as the embedded derivative would meet the scope requirements in Section 815-10-15.

b. The contract is not remeasured at fair value under otherwise applicable GAAP with changes in fair value currently included in earnings.

> > > Case X: Securitization Involving Subordination and Variable-Rate Tranches

815-15-55-224 Assume a ~~special purpose~~ special-purpose entity that holds nonprepayable fixed-rate bonds issues all of the following three tranches:

a. A senior, variable-rate financial instrument (with a limited exposure to credit losses on the fixed-rate bonds)
b. A subordinated financial instrument that is entitled to 90 percent of the difference between the fixed rate received from the bonds and the variable rate paid to the senior financial instrument (with a limited exposure to credit losses on the fixed-rate bonds)
c. A residual financial instrument that is entitled to the remainder of the fixed-rate payment from the bonds after any credit losses on the fixed-rate bonds.

815-15-55-225 Each of the three tranches in the preceding paragraph ~~The subordinated financial instrument could~~ would be a hybrid financial instrument with an embedded interest rate derivative feature that requires bifurcation analysis under paragraph 815-10-15-11 and Section 815-15-25 ~~requiring bifurcation~~ because the terms are variable rate~~, but~~ even though the entity does not hold assets that bear a variable rate. This analysis considers the structure as a whole including the related liabilities. The embedded interest rate derivative feature in the senior, variable-rate financial instrument is considered to be clearly and closely related to the host contract. ~~Therefore,~~ With respect to the subordinated financial instrument and the residual financial instrument, there could be a shortfall of cash flow after the senior interest holders are paid, due to adverse changes in interest rates, and the investor in either the subordinated interest or the residual interest might not recover substantially all of its initial recorded investment in the interest ~~(see paragraph 815-15-25-26[a]). The residual financial instrument would not have an embedded derivative for the concentration of credit risk as discussed in paragraphs 815-15-15-8 through 15-9, because the concentration of credit risk relates to the financial instruments held by the entity, but the residual instrument would have an embedded interest rate derivative.~~; thus, the embedded interest rate derivative feature is considered to be not clearly and closely related to the host contract. Therefore, the embedded interest rate derivative should be separated from the host contract and accounted for in accordance with the provisions of this Subtopic. Paragraph 815-15-15-9 is not relevant because risk features other than credit risk are present in the beneficial interests that require application of paragraph 815-10-15-11 and Section 815-15-25.

> > > Case Y: Securitization Involving Subordination and Fixed-Rate Tranches ~~Securitization that Introduces New Credit Risk~~

815-15-55-226 ~~Assume an entity holds a credit derivative referenced to Entity A and high-quality bonds, but issues beneficial interests explicitly referenced to Entity B. The beneficial interests would be a hybrid financial instrument with an embedded derivative because the cash flows relating to changes in the credit risk of Entity B are not present in the financial instruments held by the entity.~~Assume a special-purpose entity that holds prepayable fixed-rate loans issues all of the following three tranches:

a. A senior, fixed-rate financial instrument that is entitled to receive fixed-rate interest payments and all the prepayments and repayments of principal amounts received from the debtors (with a limited exposure to credit losses on the fixed-rate loans)
b. A subordinated, fixed-rate financial instrument that is entitled to receive fixed-rate interest payments and the prepayments and repayments of principal amounts received from the debtors only after the holders of the senior financial instrument have been paid in full (with a limited exposure to credit losses on the fixed-rate loans)
c. A residual financial instrument that is entitled to the remainder of the fixed-rate interest payments from the loans and the prepayments and repayments of principal amounts received from the debtors only after the holders of both the senior financial instrument and the subordinated financial instrument have been paid in full. All credit losses on the fixed-rate loans are absorbed first by the holders of the residual financial instrument.

11. Add paragraphs 815-15-55-226A through 55-226D and their related headings, with a link to transition paragraph 815-10-65-5, as follows:

815-15-55-226A Each of the three tranches in the preceding paragraph would be a hybrid financial instrument with an embedded derivative feature. Because the embedded derivative feature involves only the transfer of credit risk that is only in the form of subordination of one financial instrument to another (assuming that the investor did not pay a significant premium for the interest in the tranche), the scope exception in paragraph 815-15-15-9 applies, and the embedded credit derivative feature existing in the tranches would not be subject to the application of paragraph 815-10-15-11 and Section 815-15-25.

> > > Case Z: Partially Funded Synthetic Collateralized Debt Obligation with Multiple Tranches

815-15-55-226B Assume a special-purpose entity that holds guaranteed investment contracts and that wrote a credit default swap on a referenced credit to a third party with a significantly larger notional amount than the guaranteed investment contracts 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 guaranteed investment contracts are incurred under the credit default swap, the investors in each of the tranches might be required to provide additional funds to the special-purpose entity, which would then pass those funds on as payments to the holder of the credit default swap. Because the investors in those tranches are exposed to making potential future payments, all the embedded derivative features would be subject to the application of paragraph 815-10-15-11 and Section 815-15-25 (provided that the investor's overall contract is not a derivative in its entirety under Section 815-10-15). While the risk in those tranches is credit related, the investor can lose more than its original investment. Therefore, the credit risk for those tranches is not related only to subordination and would be evaluated under paragraph 815-10-15-11 and Section 815-15-25, particularly paragraph 815-15-25-51A.

> > > Case AA: Fully Funded Synthetic Collateralized Debt Obligation with Multiple Tranches

815-15-55-226C Assume a special-purpose entity that holds securities issued by AA-rated Entity A and that wrote a credit default swap on a referenced credit (BBB-rated Entity B) to a third party (with a smaller notional amount than the securities held) issues various tranches of credit-linked beneficial interests to investors that differ in terms of priority for the distribution of cash flows from the special-purpose entity. The assets in the special-purpose entity are sufficient to fund any losses on the credit default swap. Furthermore, none of the tranches expose the investor to making potential future payments related to defaults on the written credit default swap. Rather, the investor is exposed to a potential reduction in its future cash inflows, which is the effect of the credit risk related to the credit default swap. That reduction in future cash flows is allocated among the tranches by the subordination of one tranche to another. Each of the tranches would be a hybrid financial instrument with an embedded credit derivative feature that requires bifurcation analysis under paragraph 815-10-15-11 and Section 815-15-25 because the beneficial interests are exposed to credit risk from the securities held (Entity A) and also from credit risk introduced by the credit default swap (Entity B) and, thus, the payments to investors would be affected if either Entity A or Entity B defaults. The embedded credit derivative feature in the beneficial interests would not be clearly and closely related to the host contract under Section 815-15-25. Therefore, the embedded credit derivative feature should be separated from the host contract and accounted for in accordance with the provisions of this Subtopic. Paragraph 815-15-15-9 is not relevant because the embedded credit risk is not related solely to subordination.

> > > Case AB: Fully Funded Synthetic Collateralized Debt Obligation with a Single-Tranche Structure

815-15-55-226D Assume a special-purpose entity that holds securities issued by AA-rated Entity C and that wrote a credit default swap on a referenced credit (BBB-rated Entity D) to a third party uses a single-tranche structure to issue credit-linked beneficial interests to multiple investors. The assets in the special-purpose entity are sufficient to fund any losses on the credit default swap. Because the single-tranche structure involves no subordination of one financial instrument to another, the scope exception in paragraph 815-15-15-9 does not apply. The embedded credit derivative feature existing in the beneficial interests would be subject to the application of paragraph 815-10-15-11 and Section 815-15-25, as discussed in Case AA.

Amendment to Master Glossary

12. Add the term *Embedded Credit Derivative* and its definition to the Master Glossary and link to the first occurrence in each Subsection of Topic 815-15, with a link to transition paragraph 815-10-65-5, as follows:

Embedded Credit Derivative

An **{XREF} embedded derivative {XREF}** that is also a **{XREF} credit derivative {XREF}.**

13. Add paragraph 815-10-65-5, and its related heading, as follows:

> Transition Related to Accounting Standards Update No. 2010-11, *Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*

815-10-65-5 The following represents the transition and effective date information related to Accounting Standards Update No. 2010-11, *Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives:*

a. The pending content that links to this paragraph shall be effective for each reporting entity the first day of its first fiscal quarter beginning after June 15, 2010. Early adoption is permitted as of the first day of its first fiscal quarter beginning after issuance of this Update.
b. At the date of adoption of the pending content that links to this paragraph, an entity may elect the fair value option for any investment in a beneficial interest in a securitized financial asset, that is, the entity may irrevocably elect to measure that investment in its entirety at fair value (with changes in fair value recognized in earnings). The election

of the fair value option shall be determined on an instrument-by-instrument basis and supported by documentation completed by the beginning of the fiscal quarter of initial adoption. If the fair value option is elected at adoption for an investment, whether it had been reported at amortized cost or at fair value with changes included in other comprehensive income, the cumulative unrealized gains and losses at that date shall be included in the cumulative-effect adjustment to beginning retained earnings for the period of adoption. Separate disclosure of the amount of unrealized gains and losses that were previously unrecognized (for investments reported at amortized cost) and the amount of unrealized gains and losses reclassified from accumulated other comprehensive income (for investments reported at fair value) is permitted but not required.

c. At the date of adoption of the pending content that links to this paragraph, an entity shall assess each preexisting contract that was acquired, issued, or subject to a remeasurement (new basis) event occurring on or after the date of the reporting entity's adoption of the original guidance in paragraphs 815-10-15-11, 815-15-25-11 through 25-13, 815-15-15-8 through 15-9, and 815-15-55-224 through 55-226, to determine whether either of the following applies:
    1. Any contract for which the fair value option has not been elected contains one or more **embedded credit derivative** features that no longer qualify for the scope exception in paragraph 815-15-15-9.
    2. Any contract contains embedded derivative features that have previously been bifurcated and accounted for separately but are no longer subject to the application of paragraph 815-10-15-11 and Section 815-15-25 for potential bifurcation under the scope exception in the paragraph 815-15-15-9.

d. For contracts that contain embedded derivative features that no longer qualify for the scope exception in paragraph 815-15-15-9 and for which the fair value option has not been elected, the provisions of paragraph 815-10-15-11 and Section 815-15-25 shall be applied to those contracts at the date of adoption of the pending content that links to this paragraph to determine whether the embedded credit derivative is required to be separated from the host contract and accounted for separately. If separate accounting for the host contract and a derivative instrument is required, the carrying amount of the host contract at adoption of the content that links to this paragraph shall be based on 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 newly bifurcated hybrid instrument and the carrying amount of the hybrid instrument before bifurcation shall be recognized as a cumulative-effect adjustment to beginning retained earnings for the period of adoption.

e. For any contract containing embedded derivative features that have previously been bifurcated but are no longer subject to the application of paragraph 815-10-15-11 and Section 815-15-25, the carrying amount of the combined hybrid instrument at adoption shall be the total carrying amount of the individual components of the preexisting bifurcated hybrid instrument. No cumulative-effect adjustment to beginning retained earnings for the period of adoption is warranted.
f. An entity shall separately disclose the gross gains and gross losses that make up the cumulative-effect adjustment, determined on an instrument-by-instrument basis. Prior periods shall not be restated. An entity may, but is not required to, disclose separately the gross gains and gross losses that represent the adjustment related to the election of the fair value option and the adjustment related to the pro forma bifurcation for those hybrids for which the fair value option was not elected.

14. Amend paragraph 815-10-00-1, by adding the following items to the table, as follows:

815-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph Number	**Action**	**Accounting Standards Update**	**Date**
Embedded Credit Derivative	Added	2010-11	03/05/2010
815-10-50-4K	Amended	2010-11	03/05/2010
815-10-65-5	Added	2010-11	03/05/2010

15. Amend paragraph 815-15-00-1, by adding the following items to the table, as follows:

815-15-00-1 The following table identifies the changes made to this Subtopic.

Paragraph Number	**Action**	**Accounting Standards Update**	**Date**
Embedded Credit Derivative	Added	2010-11	03/05/2010
815-15-15-8	Superseded	2010-11	03/05/2010
815-15-15-9	Amended	2010-11	03/05/2010
815-15-25-16	Amended	2010-11	03/05/2010
815-15-25-18	Amended	2010-11	03/05/2010
815-15-25-51A	Added	2010-11	03/05/2010
815-15-55-165	Amended	2010-11	03/05/2010
815-15-55-166	Amended	2010-11	03/05/2010

Paragraph Number	Action	Accounting Standards Update	Date
815-15-55-169	Amended	2010-11	03/05/2010
815-15-55-224 through 55-226	Amended	2010-11	03/05/2010
815-15-55-226A through 55-226D	Added	2010-11	03/05/2010

The amendments in this Update were adopted by the unanimous vote of the five members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
Thomas J. Linsmeier
Leslie F. Seidman
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

BC1. The following summarizes the Board's considerations in reaching the conclusions in this Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. Board members are concerned about potential ambiguity related to the application of the embedded credit derivative scope exception in paragraphs 815-15-15-8 through 15-9 that resulted in a broader-than-intended application of the special scope exception in that paragraph. Paragraph 815-15-15-9 applies solely to the embedded credit derivatives that are related only to the subordination of one financial instrument to another.

BC3. Consequently, the Board decided to delete paragraph 815-15-15-8, amend paragraph 815-15-15-9, and provide additional amendments in this Update. The Board emphasized that credit risk that is not related only to the subordination of one financial instrument to another must be evaluated under paragraph 815-10-15-11 and Section 815-15-25. Thus, the objective of this Update is to improve financial reporting by resolving the potential ambiguity about the application of the embedded credit derivative scope exception in paragraph 815-15-15-9.

BC4. In December 2008, the Board added a project to its technical agenda that would provide clarifying language on Subtopic 815-15 about when embedded credit derivative features, including those in collateralized debt obligations and synthetic collateralized debt obligations, are not considered embedded derivatives subject to potential bifurcation and separate accounting. The Board acknowledged, however, that the potential ambiguity about the application of the scope exception in paragraphs 815-15-15-8 through 15-9 is not relevant for some synthetic collateralized debt obligations (such as certain interests in an unfunded synthetic collateralized debt obligation) if those contracts meet the definition of a derivative in their entirety. The embedded derivative provisions of paragraph 815-10-15-11 and Section 815-15-25 do not apply to a contract that meets the definition of a derivative in its entirety.

BC5. On October 13, 2009, the Board issued proposed Accounting Standards Update (Update), *Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*. That proposed Update was a revision of proposed Implementation Issue C22, which was released for public comment on January 14, 2009. The proposed Update included supplemental guidance in the Cases V and W examples about the identification of the host contract and the application of the clearly-and-closely-related notion in paragraph 815-15-25-1(a). Nine respondents submitted comment letters on the proposed Update.

BC6. Some of the respondents focused on the newly added guidance, indicating that it seemed to be a new model for identifying the host contract and applying the clearly-and-closely-related notion. They stated that the examples provided in the proposed Update did not adequately demonstrate how to apply the new model to more complex structures that may contain multiple financial assets and multiple freestanding derivatives. They also stated that the proposed Update failed to articulate a clear principle or set of principles used in the analysis of the clearly-and-closely-related notion in paragraph 815-15-25-1(a).

BC7. The Board noted that the principal purpose of the amendments in this Update is to clarify the intended application of the embedded credit derivative scope exception in paragraphs 815-15-15-8 through 15-9. Consequently, the Board decided not to consider any changes to the foreign currency and interest rate examples in Case V, Dollar-Denominated Variable-Rate Interest Involving Yen-Denominated Variable-Rate Bonds and a Cross-Currency Swap, and Case W, Variable-Rate Interest Involving Fixed-Rate Bonds and a Pay-Fixed, Receive-Variable Interest Rate Swap. The Board decided not to broadly address in this Update the application of the clearly-and-closely-related notion in paragraph 815-15-25-1(a) with respect to credit derivative features embedded in a beneficial interest in a securitized financial asset. However, the Board decided to specify that the economic characteristics and risks of an embedded credit derivative feature that is in a beneficial interest in a securitized financial asset and that exposes the holder of an interest in a tranche of that securitized financial instrument to the possibility (however remote) of being required to make potential future payments (not merely receive reduced cash inflows) would be considered to be not clearly and closely related to the economic characteristics and risks of the host contract and thus meets the criterion in paragraph 815-15-25-1(a). The Board also decided to provide more guidance on how to evaluate credit risk by indicating that if a new credit risk is added to a beneficial interest by a written credit default swap in the securitization structure, the related embedded credit derivative feature is not clearly and closely related to the host contract.

BC8. One respondent asked whether the guidance in paragraph 815-15-15-9 related only to interests in securitized financial assets or to all interests that may have embedded credit derivative features, such as interests in senior/subordinated loan participation structures that have cash flow priority features. The Board decided that paragraph 815-15-15-9 is not limited to only interests in securitized financial assets and clarified the wording accordingly.

BC9. The Board also decided to remove from the examples in the proposed Update the reminders about the disclosure requirements for credit derivatives and the application of other relevant accounting guidance to limit the amendments to issues related to the scope of the embedded credit derivative scope exception.

BC10. The proposed Update provided a fair value option for hybrid financial instruments that would be required to be separated into an embedded derivative and a host contract upon adoption of its amendments. A respondent suggested that reclassification into the trading category should be permitted for any debt security classified as available-for-sale or held-to-maturity. The Board rejected that suggestion but decided to allow a fair value option for any investment in a beneficial interest in a securitized financial asset. The election of the fair value option would be determined on an instrument-by-instrument basis at the beginning of the fiscal quarter of initial adoption. The Board emphasized that entities must ensure that an impairment analysis of the investment has been performed before the initial adoption of the amendments in this Update. The Board decided to permit but not require separate disclosure of the amount of unrealized gains and losses that was previously unrecognized (for investments reported at amortized cost) and the amount of unrealized gains and losses reclassified from accumulated other comprehensive income (for investments reported at fair value) with respect to election of the fair value option upon adoption of this Update.

BC11. One respondent stated that there could be two cumulative-effect adjustments upon transition: (a) an adjustment related to the election of the fair value option and (b) an adjustment related to the bifurcation of those hybrids for which the fair value option was not elected. That respondent asked the Board to clarify whether the disclosure of the gross gains and gross losses that make up the cumulative-effect adjustment should be applied to each of these adjustments individually or only in the aggregate. The Board decided to permit but not require disclosure of the gross gains and gross losses that make up the cumulative-effect adjustment for each of those adjustments.

BC12. Some respondents objected to the effective date in the proposed Update, which was the first day of each reporting entity's first fiscal quarter beginning after December 15, 2009. Respondents indicated that the proposed effective date would provide insufficient time to analyze all securitization structures for embedded credit derivatives that may require bifurcation. The Board decided to provide more time for adoption and established the effective date as the beginning of each reporting entity's first fiscal quarter beginning after June 15, 2010. The Board also decided to permit early adoption as of the first day of the entity's first fiscal quarter beginning after issuance of this Update.

Amendments to the XBRL Taxonomy

There are no proposed amendments to the XBRL taxonomy as a result of the amendments in this Update.