

**Notice for Recipients
of This Proposed FASB Staff Position**

This proposed FASB Staff Position (FSP) would amend FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, to improve disclosures about credit derivatives and guarantees.

The Board invites individuals and organizations to send written comments on all matters in this proposed FSP. Comments are requested from those who agree with the provisions of this proposed FSP 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 issues or question. Those who disagree with provisions of this proposed FSP are asked to describe their suggested alternatives, supported by specific reasoning. In addition to overall comments, the Board is requesting written comments on the following issue.

Effective Date

The Board believes that because of the large size of the credit derivatives market and the importance of having similar disclosures for similar instruments, the effective date for the proposed disclosures should be as soon as practicable. The Board believes that an early effective date may be practicable because the proposed disclosures for all credit derivatives within the scope of Statement 133 are similar to those already being provided for certain credit derivatives that are within the scope of Interpretation 45. However, with respect to the guarantor's disclosures currently prescribed by Interpretation 45, this proposed FSP would require an additional disclosure about the current status of the payment/performance risk of a guarantee.

The proposed effective date for this FSP is for fiscal years and interim periods ending after November 15, 2008. The Board expects to issue a final FSP in the third quarter of 2008. The Board is interested in the input from preparers of financial statements on whether the proposed disclosures

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are operational and whether the proposed effective date will provide them with adequate time to implement the final FSP. In this context, please describe any operational problems due to the fact that entities also must implement FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, which is effective for fiscal years and interim periods beginning after November 15, 2008. Please include reasons for your views on this issue and your alternative solutions.

Responses must be received in writing by June 30, 2008. Interested parties should submit their comments by email to director@fasb.org, File Reference: Proposed FSP FAS 133-b and FIN 45-c. Those without email may send their comments to “Director of Technical Application and Implementation Activities, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116, File Reference: Proposed FSP FAS 133-b and FIN 45-c.” 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 website and included as part of the project record with other project materials.

Summary

Why Is the FASB Issuing This Proposed FSP and When Will It Be Effective?

The Board issued this proposed FSP to improve disclosures about credit derivatives and guarantees. Many credit derivatives and financial guarantees are similar instruments but are not subject to similar disclosure requirements. Specific disclosures about financial guarantees and some, but not all, credit derivatives are provided in Interpretation 45. This proposed FSP would result in similar disclosures being required for similar instruments.

The requirements of this proposed FSP would be effective for financial statements issued for fiscal years and interim periods ending after November 15, 2008. Early application is encouraged.

How Will This Proposed FSP Change Current Practice?

This proposed FSP would require additional disclosures about credit derivatives and guarantees.

What Is the Effect of This Proposed FSP on Existing Accounting Pronouncements?

This proposed FSP would amend Statement 133 to require additional disclosures about credit derivatives and Interpretation 45 to require an additional disclosure about the current status of the payment/performance risk of a guarantee.

How Does This Proposed FSP Improve Financial Reporting?

This proposed FSP would improve financial reporting by enhancing the transparency of the effect of credit derivatives and guarantees on an entity's financial position, financial performance, and cash flows.

What Is the Effect of This Proposed FSP on Convergence with International Financial Reporting Standards?

In August 2005, the International Accounting Standards Board issued International Financial Reporting Standard 7, *Financial Instruments: Disclosures*. The scope of IFRS 7 includes all

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financial instruments, not just derivative instruments. The FASB decided to limit the scope of this proposed FSP to credit derivatives because of the near-term need to address the lack of disclosures about the potential exposure and cash flow effects associated with those derivatives. The FASB may consider in the future a longer term project to improve disclosures about all financial instruments and to achieve greater convergence with IFRS 7.

PROPOSED FASB STAFF POSITION

No. FAS 133-b and FIN 45-c

Title: Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45

Comment Deadline: June 30, 2008

Objective

1. This FASB Staff Position (FSP) amends FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to require additional disclosures about credit-indexed derivative instruments (hereafter referred to as credit derivatives). Examples of credit derivatives include credit default swaps, credit spread options, and credit index products. This FSP also amends FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, to require an additional disclosure about the current status of the payment/performance risk of a guarantee.

Background

2. Over the past few years, credit default swaps have become the most dominant product of the credit derivatives market. According to the "Year-End 2007 Market Survey" by the International Swaps and Derivatives Association, the estimated notional amount of outstanding credit default swaps was \$62.2 trillion in December 2007, up from \$34.4 trillion in December 2006 and \$17.1 trillion in December 2005.¹

3. The credit default swaps market has become the focus of attention for market participants and regulators because of the turmoil in credit markets during 2007 and 2008. Some sellers of credit derivatives have been faced with severe adverse conditions because a large number of referenced obligations that their credit default swaps are guaranteeing are facing actual or potential defaults. As a result, the sellers of credit default swaps may have large liabilities associated with those actual and

¹International Swaps and Derivatives Association, <http://www.isda.org/statistics/recent.html> (accessed May 2008).

potential defaults. In addition, due to the potential effects those defaults may have on their financial position, some sellers of these instruments are facing the potential of a credit downgrade or already have been downgraded by one or more credit-rating agencies.

4. Some financial statement users have expressed concerns that the disclosure requirements in Statement 133 do not adequately address the potential adverse effects of changes in credit risk on the financial position and performance of the sellers of credit derivatives. In March 2008, the Board added a short-term project to its agenda to improve disclosures about credit derivatives.

5. Many credit derivatives and financial guarantee contracts are similar instruments providing similar support upon default of the underlying obligation. A financial guarantee contract generally refers to circumstances in which the guaranteed party owns the underlying guaranteed obligation. However, in the case of many credit derivatives, the guaranteed party does not necessarily own the underlying assets that are being referenced in the derivative contract. Regardless of this differentiating feature, the risks and rewards of a financial guarantee or a credit derivative are substantially similar.

6. Although credit derivatives are similar to guarantees, the disclosure requirements in Interpretation 45 apply to only some, but not all, credit derivatives. For example, credit derivatives that require the “buyer” of credit protection to own the underlying referenced obligation are within the scope of Interpretation 45, while credit derivatives that do not have such a requirement are generally outside the scope of Interpretation 45. The Board believes that instruments with similar risks and rewards should have similar disclosures and, therefore, the disclosures in Interpretation 45 should apply to all credit derivatives.

7. In addition to the guarantor’s disclosures currently required for guarantees under Interpretation 45, the Board believes that the disclosure about the current status of the payment/performance risk of the guarantee or the credit derivative would be relevant to financial statement users.

<p>All paragraphs in the FSP have equal authority. Paragraphs in bold set out the main principles.</p>
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FASB Staff Position

Scope

8. **This FSP applies to credit derivatives within the scope of Statement 133.** Credit derivatives generally are contracts in which the underlying is related to the credit risk of a specified entity (or a group of entities) or an index based on a group of entities. Examples of credit derivatives include, but are not limited to, credit default swaps, credit spread options, and credit index products.

Amendment to Disclosure Requirements of Statement 133

9. **A seller² of credit derivatives shall disclose information about its credit derivatives to enable users of financial statements to assess the potential effect of those derivatives on its financial position, financial performance, and cash flows.**

10. For each statement of financial position presented, the seller of a credit derivative shall disclose for each credit derivative (the term *credit derivative* includes groups 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 the approximate term of the credit derivative, the reason(s) for entering into the credit derivative, the events or circumstances that would require the seller to perform under the credit derivative, and the current status of the payment/performance risk of the credit derivative. For example, the current status of the payment/performance risk of the credit derivative could be indicated by either current external credit ratings of the underlying, when available, or current internal categories/groupings based on the manner in which the seller manages its risk.
- b. The maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative. That maximum potential amount of future payments 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 under (d) below). If the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the seller shall disclose the reasons why it cannot estimate the maximum potential amount.

²The term *seller* includes the party that assumes credit risk, which could be a guarantor in a guarantee-type contract, and any party that provides the credit protection in an option-type contract, a credit default swap, or any other credit derivative contract. A seller is also sometimes referred to as a writer of the contract.

- c. The fair value of the credit derivative.
- d. The nature of (1) any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified pre-agreed 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. The seller shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets 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 should consider the effect of any purchased credit protection with an identical underlying(s).

Amendment to Disclosure Requirements of Interpretation 45

11. The proposed disclosures for sellers of credit derivatives are substantially similar to those currently required for guarantors under paragraph 13 of Interpretation 45 except for the disclosure about the current status of the payment/performance risk of the credit derivative. To have similar disclosures for instruments with similar risks and rewards, this FSP amends paragraph 13(a) of Interpretation 45 to require disclosure of the current status of the payment/performance risk of the guarantee. The current status of the payment/performance risk of the guarantee could be indicated by either current external credit ratings, when available, or current internal categories/groupings based on the manner in which the guarantor manages its risk.

Effective Date and Transition

12. This FSP shall be effective for financial statements issued for fiscal years and interim periods ending after November 15, 2008. Early application is encouraged.

13. This FSP encourages but does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In years after initial adoption, this FSP requires comparative disclosures only for periods subsequent to initial adoption.

<p>The provisions of this FSP need not be applied to immaterial items.</p>

Appendix

AMENDMENT TO STATEMENT 133

A1. Statement 133 is amended as follows: [Added text is underlined.]

a. Paragraph 44DD is added as follows:

A seller^{12a6} of credit derivatives shall disclose information about its credit derivatives to enable users of financial statements to assess the potential effect of those derivatives on its financial position, financial performance, and cash flows. For each statement of financial position presented, the seller of a credit derivative shall disclose for each credit derivative (the term *credit derivative* includes groups 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 the approximate term of the credit derivative, the reason(s) for entering into the credit derivative, the events or circumstances that would require the seller to perform under the credit derivative, and the current status of the payment/performance risk of the credit derivative. For example, the current status of the payment/performance risk of the credit derivative could be indicated by either current external credit ratings of the underlying, when available, or current internal categories/groupings based on the manner in which the seller manages its risk.
- b. The maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative. That maximum potential amount of future payments 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 under (d) below). If the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the seller shall disclose the reasons why it cannot estimate the maximum potential amount.
- c. The fair value of the credit derivative.
- d. The nature of (1) any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified pre-agreed 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. The seller shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets 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 should consider the effect of any purchased credit protection with an identical underlying(s).

^{12a6}The term *seller* includes the party that assumes credit risk, which could be a guarantor in a guarantee-type contract, and any party that provides the credit protection in an option-type contract, a credit default swap, or any other credit derivative contract. A seller is also sometimes referred to as a writer of the contract.

AMENDMENTS TO INTERPRETATION 45

A2. Interpretation 45 is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

a. Paragraph 6(h) is added as follows:

A guarantee that is accounted for as a derivative instrument at fair value under Statement 133.

b. Paragraph 7(a):

~~a. A guarantee that is accounted for as a derivative instrument at fair value under Statement 133.~~

c. Paragraph 13(a):

a. The nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, ~~and~~ the events or circumstances that would require the guarantor to perform under the guarantee, and the current status of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of the guarantee could be indicated by either current external credit ratings, when available, or current internal categories/groupings based on the manner in which the guarantor manages its risk.