FINANCIAL ACCOUNTING SERIES

EXPOSURE DRAFT

Proposed Accounting Standards Update

Issued: October 13, 2009
Comments Due: November 12, 2009

Derivatives and Hedging (Topic 815)

Scope Exception Related to Embedded Credit Derivatives

This Exposure Draft of a proposed Accounting Standards Update of Topic 815 is issued by the Board for public comment. Written comments should be addressed to:

Technical Director
File Reference No. 1740-100

Financial Accounting Standards Board
of the Financial Accounting Foundation

The *FASB Accounting Standards Codification*™ is the single source of authoritative nongovernmental U.S. generally accepted accounting principles. An Accounting Standards Update is not authoritative; rather, it is a document that communicates the specific amendments that change the Accounting Standards Codification. It also provides other information to help a user of U.S. GAAP understand how and why U.S. GAAP is changing and when the changes will be effective.

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites individuals and organizations to send written comments on all matters in this Exposure Draft of a proposed Accounting Standards Update. Responses from those wishing to comment on the Exposure Draft must be received in writing by November 12, 2009. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1740-100. Those without email should send their comments to "Technical Director, File Reference No. 1740-100, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116." Do not send responses by fax.

All comments received constitute part of the FASB's public file. The FASB will make all comments publicly available by posting them to its website and by making them available in its public reference room in Norwalk, Connecticut.

An electronic copy of this Exposure Draft is available on the FASB's website until the FASB issues a final Accounting Standards Update.

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

Proposed Accounting Standards Update

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

Questions have arisen in practice about the intended breadth of the embedded credit derivative scope exception in paragraph 815-15-15-9. 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 is meant by the first sentence in paragraph 815-15-15-9 and whether other embedded credit derivative features, including those in some collateralized debt obligations and synthetic collateralized debt obligations, are considered embedded derivative features that are not subject to the application of paragraph 815-10-15-11 and Section 815-15-25.

Who Would Be Affected by the Amendments in This Proposed 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 would be affected by the amendments in this proposed Update because the amendments would clarify that the embedded credit derivative scope exception in paragraph 815-15-15-9 does not apply to such contracts.

What Are the Main Provisions?

This proposed Update provides amendments to Subtopics 815-15 as follows:

1. This proposed Update amends Codification Subtopic 815-15, Derivatives and Hedging—Embedded Derivatives, to clarify the scope exception under paragraph 815-15-15-9 for embedded credit derivative features related to the transfer of credit risk in the form of subordination of one financial instrument to another. This proposed Update addresses 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. In addition, this proposed Update provides guidance on the application of paragraph 815-15-25-1(a), including amendments to the examples in paragraphs 815-15-55-222 through 55-223, which do not involve embedded credit derivatives.

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 an embedded derivative feature that shall not be subject to the application of Section 815-15-25. Thus, only the embedded credit derivative feature between the tranche holders created by subordination is not subject to the application of Section 815-15-25 and shall 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) would not qualify for the scope exception and would be subject to the application of Section 815-15-25 for potential bifurcation:
    a. The holder of an interest in a tranche of those securitized financial instruments is exposed to the possibility (however remote) of being required to make potential future payments (not merely receive reduced cash inflows); consequently, any transfer of credit risk for that tranche could not be considered to be *only* in the form of subordination of one financial instrument to another because those future payments are considered to be related to credit risk outside that created by subordination.
    b. 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 (including 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.

How Do the Proposed Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles and Why Would They Be an Improvement?

The Board has proposed 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 paragraph 815-15-15-9.

When Would the Amendments Be Effective?

The effective date of the amendments in this proposed Update for each reporting entity would be the first day of its first fiscal quarter beginning after December 15, 2009.

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

IFRS does not contain an embedded credit derivative scope exception comparable to the scope exception in paragraph 815-15-15-9. Because this proposed Update would narrow the breadth of the embedded credit derivative scope exception in paragraph 815-15-15-9, the proposed change would move GAAP closer to converging with IFRS.

Questions for Respondents

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

Issue 1: Do the amendments resolve the potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraph 815-15-15-9?

Issue 2: Are the revisions to the existing examples and the new examples in paragraphs 815-15-55-226 through 55-226E effective in clarifying the breadth of the embedded credit derivative scope exception in paragraph 815-15-15-9?

Issue 3: Is the proposed effective date operational and the transition provisions appropriate?

Amendments to the *FASB Accounting Standards Codification*™

Introduction

The Accounting Standards Codification is amended as described in paragraphs 1–6. 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 <u>underlined</u> and deleted text is ~~struck out~~.

Amendments to Topic 815

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

815-10-50-4K A seller of **credit derivatives** shall disclose information about its credit derivatives and hybrid instruments that have embedded credit derivatives (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. 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
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.

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

> > 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 2009-XX.

3. Amend paragraph 815-15-15-9, with a link to transition paragraph 815-10-65-XX, 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 tranche holders 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. 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); consequently, any transfer of credit risk for that tranche shall not be considered to be only in the form of subordination of one financial instrument to another because those future payments are considered to be related to credit risk outside that 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 may qualify for the scope exception.)
b. The holder owns an interest in a single-tranche securitization vehicle; therefore, the subordination of one tranche to another is not relevant.

4. Amend paragraphs 815-15-55-222 through 55-226 and their related headings, with a link to transition paragraph 815-10-65-XX, as follows:

> > > Case V: Dollar-Denominated Variable-Rate Interest Involving Yen-Denominated Variable-Rate Bonds and a Matching Cross-Currency Swap

815-15-55-222 Assume a dollar-denominated variable-rate interest is issued by a special-purpose entity that holds yen-denominated variable-rate bonds as assets and a matching cross-currency swap to pay yen and receive dollars. If the variable 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 variable-rate interest would not have~~ the bifurcation of an embedded derivative feature would not be required under paragraph 815-10-15-11 and Section 815-15-25 because the economic characteristics and risks of the embedded derivative feature (the matching cross-currency swap to pay yen and receive dollars) would be clearly and closely related to the economic characteristics and risks of the host contract (an investment in yen-denominated variable-rate bonds)~~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~~.

> > > Case W: Variable-Rate Interest Involving Fixed-Rate Bonds and a Matching Pay-Fixed, Receive-Variable Interest Rate Swap

815-15-55-223 Assume a variable-rate interest is issued by a special-purpose entity that holds fixed-rate bonds as assets and a matching pay-fixed, receive-variable interest rate swap. The variable-rate interest would not have an embedded derivative feature requiring bifurcation under paragraph 815-10-15-11 and Section 815-15-25 because the economic characteristics and risks of the embedded derivative feature (the matching pay-fixed, receive-variable interest rate swap) would be clearly and closely related to the economic characteristics and risks of the host contract (the investment in fixed-rate bonds) ~~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, the variable-rate interest provisions would have to be evaluated for an embedded derivative under paragraph 815-15-25-26 because the underlying is a single interest rate or interest rate index ~~financial instruments held by the entity might not provide the necessary cash flows~~.

> > > Case X: Securitization Involving Subordination

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

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 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 The embedded credit derivative feature related to the credit loss allocation among tranches is subject to the application of paragraph 815-10-15-11 and Section 815-15-25 because the related transfer of credit risk is not created only by the subordination of one financial instrument to another, as discussed in paragraph 815-15-15-9, but also includes the introduction of variable-rate-based payments, which enables the senior, floating-rate financial instrument to receive amounts in excess of the fixed rate on the special-purpose entity's bonds. Each of the three tranches ~~The subordinated financial instrument could~~ would be a hybrid financial instrument with an embedded interest rate derivative feature that requires bifurcation analysis ~~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 senior, variable-rate financial instrument does not meet the conditions in paragraphs 815-15-25-26 through 25-29; thus, the embedded interest rate derivative feature 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]).~~ (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. Because the investor in either the subordinated interest or the residual interest might not recover substantially all of its initial recorded investment in the interest, the investors' investments in the subordinated interests and in the residual interests issued by the special-purpose entity would be subsequently measured at fair value in accordance with the provisions of paragraph 860-20-35-2.

> > > Case Y: Partially Funded Synthetic Collateralized Debt Obligation with Multiple 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 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 one or more (but not all) tranches would 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.

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

815-15-55-226A For the tranches that do not expose the investor to making potential future payments, the investor's embedded credit derivative feature that relates to the transfer of credit risk that is only in the form of subordination of one tranche to another (that is, the embedded credit derivative feature between the tranche holders that creates the subordination) is an embedded derivative feature that, under paragraph 815-15-15-9, is not subject to the application of paragraph 815-10-15-11 and Section 815-15-25. However, the investor's embedded credit derivative feature that relates to the written credit default swap would still be subject to the application of paragraph 815-10-15-11 and Section 815-15-25.

815-15-55-226B For those tranches that expose the investor 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 must be evaluated under paragraph 815-10-15-11 and Section 815-15-25. The economic characteristics and risks of the embedded credit-related derivative (a compound derivative related to both the subordination provisions and the credit default swap) would not be clearly and closely related to the economic characteristics and risks of the host contract (the guaranteed investment contract).

815-15-55-226C With respect to determining fair value for the tranches that do not expose the investor to making potential payments, the fair value of each tranche's derivative related to the credit default swap is based on its expected cash flow as affected by the subordination provisions even though no separate derivative is recognized for the embedded credit derivative feature between the tranche holders created by the subordination. Each investor would be required to consider the disclosure requirements for credit derivatives.

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

815-15-55-226D Assume a special-purpose entity 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 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 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 swaps. That reduction in future cash flows is allocated among the tranches by the subordination of one tranche to another. Under paragraph 815-15-15-9, the investor's embedded credit derivative feature resulting from the subordination between the tranche holders is an embedded derivative feature that is not subject to the application of paragraph 815-10-15-11 and Section 815-15-25 because it relates to the transfer of credit risk that is only in the form of subordination of one tranche to another. However, the investor's embedded credit derivative feature that relates to the written credit default swap on a referenced credit would still be subject to the application of paragraph 815-10-15-11 and Section 815-15-25. The economic characteristics and risks of that embedded credit-related derivative (the written credit default swap on a referenced credit) would not be clearly and closely related to the economic characteristics and risks of the host contract (the U.S. Treasury securities). With respect to determining fair value for the tranches that do not expose the investor to making potential payments, the fair value of each tranche's derivative related to the credit default swap is based on its expected cash flow as affected by the subordination provisions even though no separate derivative is recognized for the embedded credit derivative feature between the tranche holders created by the subordination. Each investor would be required to consider the disclosure requirements for credit derivatives.

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

815-15-55-226E Assume a special-purpose entity that holds U.S. Treasury securities and that wrote a credit default swap on a referenced credit 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 and the embedded credit derivative feature (related to the credit default swap) in the beneficial interests issued by the special-purpose entity is subject to the application of paragraph 815-10-15-11 and Section 815-15-25. If the fair value option is not elected by the investor and the criterion in paragraph 815-15-25-1(c) is met, paragraph 815-10-15-11 and Section 815-15-25 would require bifurcation and separate accounting because the economic characteristics and risks of the embedded credit-related derivative (the credit default swap on a referenced credit) would not be clearly and closely related to the economic characteristics and risks of the host contract (the U.S. Treasury securities).

Amendments to Subtopic 815-10

6. Add paragraph 815-10-65-XX, and its related heading, as follows:

> Transition Related to Accounting Standards Update No. 2009-XX, *Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*

815-10-65-XX The following represents the transition and effective date information related to Accounting Standards Update No. 2009-XX, *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 December 15, 2009.
b. 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 guidance in paragraphs 815-10-15-11, 815-15-25-11 through 25-13, 815-15-15-8 through 15-9, and 815-15-55-222 through 55-226, to determine whether either of the following applies:
    1. Any contract contains one or more embedded credit derivatives features that, under paragraph 815-15-15-9, no longer qualify for the scope exception in that paragraph
    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.

c. For contracts containing embedded derivative features that no longer qualify for the scope exception in paragraph 815-15-15-9, 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.
    1. If a contract (that is, hybrid instrument) would be required to be separated into a host contract and a derivative instrument under paragraph 815-15-15-9 and if the contract is a hybrid financial instrument, the entity may elect the fair value option, that is, may irrevocably elect to measure that contract 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 end of the fiscal quarter of initial adoption.
    2. If the fair value option is not elected for a hybrid contract that is required to be separated into a host contract and a derivative instrument under paragraph 815-15-15-9, the carrying amount of the host contract at adoption of the content that links to this paragraph shall 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 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. If the fair value option is elected at adoption, any difference between the fair value of the hybrid instrument and its carrying amount shall be recognized as a cumulative-effect adjustment to beginning retained earnings for the period of adoption.
d. 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.
e. 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.

Background Information and Basis for Conclusions

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed 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 that investors and other users of financial statements are being denied relevant information about certain credit derivatives that are embedded in other instruments because those embedded credit derivatives were not being bifurcated from their host contracts and accounted for separately as derivatives at fair value. The failure to account for those certain credit derivatives separately apparently is attributable to potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraph 815-15-15-9 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 amend paragraph 815-15-15-9 and provide the guidance in this proposed 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 proposed Update is to improve financial reporting by resolving the potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraph 815-15-15-9.

BC4. In December 2008, the FASB 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. But the Board acknowledged that the potential ambiguity about the application of the scope exception in paragraph 815-15-15-9 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 its 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. This proposed Update is a revision of proposed Implementation Issue C22, which was released for public comment on January 14, 2009. Because that previous exposure document was in legacy literature format, an appendix has been added in legacy literature format to facilitate a better understanding of the changes reflected in this proposed Update.

Amendments to the XBRL Taxonomy

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

Appendix: The Proposed Scope Exception for Embedded Credit Derivative Features in the Format of the Legacy Literature

Proposed Statement 133 Implementation Issue No. C22

INTRODUCTION

This proposed Implementation Issue addresses the scope exception for embedded credit derivative features related to the transfer 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 to be embedded derivatives that should not be analyzed under paragraphs 12 and 14A for potential bifurcation and separate accounting. In addition, guidance is provided regarding the application of paragraph 12(a), including amendments to Examples 35 and 36, which do not involve embedded credit derivatives. 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

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 an embedded derivative feature that shall not be subject to the application of paragraphs 12, 13, and 14A. Thus, only the embedded credit derivative feature between the tranche holders created by subordination is not subject to the application of paragraphs 12 and 14A and shall not be analyzed under those paragraphs for potential bifurcation from the host contract and separate accounting as a derivative. 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 would be subject to the application of paragraphs 12 and 14A for potential bifurcation:

1. The holder of an interest in a tranche of those securitized financial instruments is exposed to the possibility (however remote) of being required to make potential future payments (not merely receive reduced cash inflows); consequently, any transfer of credit risk for that tranche could not be considered to be *only* in the form of subordination of one financial instrument to another because those future payments are considered to be related to credit risk outside that created by subordination.
2. The holder owns an interest in a single-tranche securitization vehicle; therefore, the subordination of one tranche to another is not relevant.

Other embedded credit derivative features, including those in some CDOs and synthetic CDOs, are considered embedded derivatives subject to the application of paragraphs 12 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 underlined and deleted text is ~~struck out~~.]

Paragraph 14B:

> ***Scope exception from applying paragraphs 12 and 14A.*** ~~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~~ 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 paragraphs 12 and 14A of ~~under this~~ Statement. Only the embedded credit derivative feature created by subordination between the tranche holders is not subject to the application of paragraphs 12 and 14A. 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 paragraphs 12 and 14A 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 would be subject to the application of paragraphs 12 and 14A for potential bifurcation:

a. 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); consequently, any transfer of credit risk for that tranche shall not be considered to be *only* in the form of subordination of one financial instrument to another because those future payments are considered to be related to credit risk outside that 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 may qualify for the scope exception.)
b. The holder owns an interest in a single-tranche securitization vehicle; therefore, the subordination of one tranche to another is not relevant.

Paragraph 200A:

Example 35: A Dollar-Denominated Floating-Rate Interest Issued by an SPE That Holds Yen-Denominated Floating-Rate Bonds as Assets 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 feature would not be required under paragraphs 12, 13, and 14A because the economic characteristics and risks of the embedded derivative feature (the matching cross-currency swap to pay yen and receive dollars) would be clearly and closely related to the economic characteristics and risks of the host contract (an investment in yen-denominated floating-rate bonds) ~~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 as Assets and a Matching Pay-Fixed, Receive-Variable Interest Rate Swap. The variable-rate interest would *not* have an embedded derivative feature requiring bifurcation under paragraphs 12, 13, and 14A because the economic characteristics and risks of the embedded derivative feature (the matching pay-fixed, receive-variable interest rate swap) would be clearly and closely related to the economic characteristics and risks of the host contract (the investment in fixed-rate bonds) ~~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, the variable-rate interest provisions would have to be evaluated for an embedded derivative that potentially warrants bifurcation under paragraph 13 because the underlying is a single interest rate or interest rate index ~~financial instruments held by the entity might not provide the necessary cash flows~~.

Paragraph 200C:

Example 37: A Securitization Involving Subordination. An SPE that holds fixed-rate bonds issues (a) a senior, floating-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 and the floating rate paid to the senior financial instrument (with a limited exposure to credit losses on the fixed-rate bonds), and (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. The embedded credit derivative feature related to the credit loss allocation among tranches is subject to the application of paragraphs 12 and 14A because the related transfer of credit risk is not created only by the subordination of one financial instrument to another, as discussed in paragraph 14B, but also includes the introduction of floating-rate-based payments, which enables the senior, floating-rate financial instrument to receive amounts in excess of the fixed rate on the SPE's bonds. Each of the three tranches ~~The subordinated financial instrument could~~ would be a hybrid financial instrument with an embedded interest rate derivative feature that requires bifurcation analysis ~~requiring bifurcation~~ because the terms are floating-rate, ~~but~~ even though the entity does not hold assets that bear a floating rate. This analysis considers the structure as a whole including the related liabilities. The senior, floating-rate financial instrument meets neither of the conditions in paragraphs 13(a) and 13(b); thus, the embedded interest rate derivative feature 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 13(a));~~.~~ ~~The residual financial instrument would not have an embedded derivative for the concentration of credit risk as discussed in paragraph 14B, 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. Because the investor in either the subordinated interest or the residual interest might not recover substantially all of its initial recorded investment in the interest, the investors' investments in the subordinated interests and in the residual interests issued by the SPE would be subsequently measured at fair value in accordance with the provisions of paragraph 14 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as amended by FASB Statement No. 166, *Accounting for Transfers of Financial Assets.*

Paragraph 200D:

Example 38: [Superseded November 2009.]~~A Securitization That Introduces New Credit Risk.~~ ~~An entity holds a credit derivative referenced to Company A and high-quality bonds, but issues beneficial interests explicitly referenced to Company 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 Company B are not present in the financial instruments held by the entity.~~

Paragraph 200E is added as follows:

Example 39: Fully Funded Synthetic CDO with a Single-Tranche Structure. 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) uses a single-tranche structure to issue credit-linked beneficial interests to multiple investors. The assets in the SPE 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 14B does not apply and the embedded credit derivative feature (related to the credit default swap) in the beneficial interests issued by the SPE is subject to the application of paragraphs 12 and 14A of this Statement. If the fair value option is not elected by the investor and the criterion in paragraph 12(c) is met, those paragraphs would require bifurcation and separate accounting because the economic characteristics and risks of the embedded credit-related derivative (the credit default swap on a referenced credit) would not be clearly and closely related to the economic characteristics and risks of the host contract (the U.S. Treasury securities).

Paragraph 200F is added as follows:

Example 40: Fully Funded Synthetic CDO with Multiple Tranches. 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. Further, none of the tranches expose the investor to 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. Under paragraph 14B, the investor's embedded credit derivative feature resulting from the subordination between the tranche holders is an embedded derivative feature that is not subject to the application of paragraphs 12 and 14A of this Statement because it relates to the transfer of credit risk that is only in the form of subordination of one tranche to another. However, the investor's embedded credit derivative feature that relates to the written credit default swap on a referenced credit would still be subject to the application of paragraphs 12 and 14A of Statement 133. The economic characteristics and risks of that embedded credit-related derivative (the written credit default swap on a referenced credit) would not be clearly and closely related to the economic characteristics and risks of the host contract (the U.S. Treasury securities). With respect to determining fair value for the tranches that do not expose the investor to making potential payments, the fair value of each tranche's derivative related to the credit default swap is based on its expected cash flow as affected by the subordination provisions even though no separate derivative is recognized for the embedded credit derivative feature between the tranche holders created by the subordination. Each investor would be required to consider the disclosure requirements for credit derivatives.

Paragraph 200G is added as follows:

Example 41: Partially Funded Synthetic CDO with Multiple Tranches. 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 (but not all) tranches would be required to provide additional funds to the SPE, which would then pass those funds on as payments to the holder of the credit default swap.

a. For the tranches that do not expose the investor to making potential future payments, the investor's embedded credit derivative feature that relates to the transfer of credit risk that is only in the form of subordination of one tranche to another (that is, the embedded credit derivative feature between the tranche holders that creates the subordination) is an embedded derivative feature that, under paragraph 14B, is not subject to the application of paragraphs 12 and 14A of this Statement. However, the investor's embedded credit derivative feature that relates to the written credit default swap would still be subject to the application of paragraphs 12 and 14A of this Statement.
b. For those tranches that expose the investor to making potential future payments, all the embedded derivative features would be subject to the application of paragraphs 12 and 14A (provided that the investor's overall contract is not a freestanding derivative in its entirety under paragraph 6 of this Statement). 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 must be evaluated under paragraphs 12 and 14A. The economic characteristics and risks of the embedded credit-related derivative (a compound derivative related to both the subordination provisions and the credit default swap) would not be clearly and closely related to the economic characteristics and risks of the host contract (the GIC).

With respect to determining fair value for the tranches that do not expose the investor to making potential payments, the fair value of each tranche's derivative related to the credit default swap is based on its expected cash flow as affected by the subordination provisions even though no separate derivative is recognized for the embedded credit derivative feature between the tranche holders created by the subordination. Each investor would be required to consider the disclosure requirements for credit derivatives.

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, 2009.

At the date of adoption for the implementation guidance in this Issue, 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 FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments,* to determine whether (a) any contract contains one or more embedded credit derivatives features that, under the revised paragraph 14B, no longer qualify for the scope exception in that paragraph or (b) any contract contains embedded derivative features that have previously been bifurcated and accounted for separately but are no longer subject to the application of paragraphs 12 and 14A for potential bifurcation under the scope exception in the revised paragraph 14B.

1. For contracts containing embedded derivative features that no longer qualify for the scope exception in paragraph 14B, the provisions of paragraphs 12 and 14A shall be applied to those 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 under the revised paragraph 14B and if the contract is a hybrid financial instrument, the entity may elect the fair value option, that is, may irrevocably elect to measure that contract 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 end of the fiscal quarter of initial adoption. If the fair value option 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 shall 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 newly bifurcated hybrid instrument and the carrying amount of the hybrid instrument prior to bifurcation shall be recognized as a cumulative-effect adjustment to beginning retained earnings for the period of adoption. If the fair value option is elected at adoption, any difference between the fair value of the hybrid instrument and its carrying amount shall be recognized as a cumulative-effect adjustment to beginning retained earnings for the period of adoption.
2. For any contract containing embedded derivative features that have previously been bifurcated but are no longer subject to the application of paragraphs 12 and 14A, 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.

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.

BACKGROUND INFORMATION

In December 2008, the FASB added a project to its 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 potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraph 14B. The objective is not to achieve convergence with International Financial Reporting Standards regarding when embedded credit derivative features are or are not considered embedded derivatives subject to potential bifurcation and separate accounting.

Need for Guidance

Questions have arisen in practice about the intended breadth of the embedded credit derivative scope exception in paragraph 14B, as amended by FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*. It is clear that the transfer of credit risk that is only in the form of subordination of one financial instrument to another (resulting in a concentration of credit risk) shall be considered an embedded derivative feature that is not subject to potential bifurcation and separate accounting under paragraphs 12 and 14A of Statement 133. 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 embedded derivative features that are not subject to the application of paragraphs 12 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 derivative features. That broad application of the scope exception for embedded credit derivative features 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 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) if the contract meets the definition of a derivative in its entirety. The embedded derivative provisions of paragraphs 12 and 14A do not apply to a contract that meets the definition of a derivative in its entirety.

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NOTE: The style of this Appendix is used to assist the reviewer of the proposed Accounting Standards Update in understanding the revised, proposed amendments to GAAP by identifying the changes made to the previous version of the proposed amendments to the legacy literature.