

Title: Embedded Derivatives: Beneficial Interests Issued by Qualifying Special-Purpose Entities
Paragraph references: 12, 60, 61
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Note: This issue was not resolved by the issuance of either FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, (issued in April 2003), or FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments* (issued in February 2006). Resolution of this issue ~~is had been~~ expected to follow completion of a limited-scope interpretation of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. As a result, the guidance in this issue ~~remains remained~~ tentative and ~~is was~~ subject to change pending the FASB's further consideration of those issues. On September 15, 2008, the FASB released a revised Exposure Draft of a proposed FASB Statement, Accounting for Transfers of Financial Assets, which would amend Statement 140. The Exposure Draft would remove the concept of a qualifying SPE from Statement 140. If the Exposure Draft is finalized as proposed, the guidance in this issue would no longer be relevant and this issue would be withdrawn.

QUESTION

How should a beneficial interest issued by a qualifying special-purpose entity (SPE), as defined by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, be evaluated under paragraph 12 of Statement 133?

BACKGROUND

Paragraph 12 of Statement 133 requires that an embedded derivative be accounted for separately as a freestanding derivative instrument if all of the following criteria are met: (a) the economic characteristics of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract, (b) the hybrid instrument is not remeasured at fair value with changes in fair value reported in earnings as they occur, and (c) a separate instrument with the same terms as the embedded derivative instrument would meet the definition of a derivative instrument subject to the requirements of Statement 133.

As discussed in tentative Statement 133 Implementation Issue No. D2, "Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1)" (which was withdrawn in March 2003), a beneficial interest issued in a securitization transaction that does not meet the definition of a derivative in its entirety must be evaluated under paragraph 12 similar to any other security that may contain terms that affect

some or all of the cash flows required by the contract in a manner similar to a derivative instrument. In discussing the application of paragraph 12, tentative Implementation Issue D2 had stated:

In evaluating whether a beneficial interest that does not meet the definition of a derivative has an embedded derivative requiring bifurcation under paragraph 12, a beneficial interest holder must consider the terms of the beneficial interest itself and the aggregate sources of cash flows that are available to service the interest. That is, beneficial interest holders must consider whether the nature and extent of cash flows generated by the securitized financial instruments are or are not consistent with the stated terms of the interest. Further, the consideration of whether a beneficial interest contains an embedded derivative that must be bifurcated should include the priority of interests (that is, the “cash waterfall”), the relative concentration of risks across various tranches of securities issued by the securitization vehicle, and the nature of any additional credit enhancement or other guarantee available to the interests.

Paragraphs 60 and 61 provide additional guidance for determining when a hybrid instrument contains an embedded derivative that is not clearly and closely related to the host contract.

Questions have been raised regarding the application of the bifurcation guidance in Statement 133 to beneficial interests issued by qualifying SPEs. Specifically, some have questioned whether an investor’s beneficial interest in a qualifying SPE is automatically a hybrid instrument that contains an embedded derivative requiring bifurcation if the qualifying SPE holds a combination of debt or equity securities and derivative instruments. In addition, some have questioned how to determine the nature of the host contract in performing the bifurcation analysis.

Four examples of securitization transactions involving qualifying SPEs are outlined below.

Example 1

A qualifying SPE holds fixed-rate corporate bonds (7 percent coupon rate) and a pay-fixed (at 7 percent), receive-variable (LIBOR) interest rate swap. The notional amount of the swap matches the principal amount of the corporate bonds, and the expiration date of the swap matches the maturity date of the bonds. An investor purchases a beneficial interest issued by the qualifying SPE that has an interest rate based on LIBOR and a maturity date that is the same as the securitized instruments.

Example 2

A qualifying SPE holds EURO-denominated variable-rate corporate bonds and a pay-floating-EURO and receive-fixed-U.S. dollar foreign currency interest rate swap. The notional amount of the swap matches the principal amount of the corporate bonds, and the index on which the swap’s variable rate is based matches the index on which the bonds’ variable rate is based. Also,

the swap's repricing dates match the repricing dates of the bonds, and the expiration date of the swap matches the final maturity date of the bonds. An investor purchases a beneficial interest issued by the qualifying SPE that is denominated in U.S. dollars and has a fixed interest rate. The beneficial interest has a maturity date that is the same as the securitized instruments.

Example 3

A qualifying SPE holds 1000 shares of common stock of Company ABC. An investor purchases a beneficial interest issued by the qualifying SPE in the form of private-company equity. The investor receives all distributions and dividends related to the shares of Company ABC common stock held by the qualifying SPE. However, the investor does not have voting rights typical of a Company ABC shareholder. For the purposes of this example, assume that the investment in Company ABC common stock is a passive investment that meets the requirements discussed in paragraph 39 of Statement 140.

Example 4

A qualifying SPE holds 1000 shares of common stock of Company XYZ. An investor purchases a senior beneficial interest issued by the qualifying SPE that has a fixed interest rate. The transferor holds a beneficial interest in the form of private-company equity, which absorbs the first losses related to the securitized shares of common stock. There is no third-party guarantee provided for the senior interest. For the purposes of this example, assume that the investment in Company XYZ common stock is a passive investment that meets the requirements discussed in paragraph 39 of Statement 140.

For purposes of the above examples, assume that the investor does not consolidate the qualifying SPE.

RESPONSE

For the purposes of applying the guidance in paragraphs 12, 60 and 61 of Statement 133, all beneficial interests issued by qualifying SPEs (as defined by Statement 140) that contain embedded derivative features should be considered hybrid instruments with debt host contracts. Accordingly, if a beneficial interest in a qualifying SPE incorporates a return that is based on a risk type other than interest rates (such as an equity-based return), the embedded derivative that incorporates the equity-based return would not be clearly and closely related to the host contract and would require bifurcation. In addition, if a beneficial interest in a qualifying SPE incorporates a return based on interest rates, but the beneficial interest can be contractually settled in such a way that the investor would not recover substantially all of its initial recorded investment due to an embedded interest rate feature, the embedded derivative would not be considered clearly and closely related to the debt host contract and would require bifurcation.

A beneficial interest issued by a qualifying SPE should not automatically be considered a hybrid instrument that contains an embedded derivative requiring bifurcation simply because the

qualifying SPE holds a combination of instruments—that is, debt and equity securities and derivative instruments. As previously discussed in tentative Implementation Issue D2, in evaluating whether a beneficial interest has an embedded derivative requiring bifurcation under paragraph 12, a beneficial interest holder must consider both the terms of the beneficial interest it holds and the aggregate sources of cash flows that are available to service the interest.

The examples in the Background section are analyzed as follows.

Example 1

The investor holds a beneficial interest with a payoff equal to a variable-rate bond based on LIBOR. The beneficial interest does not incorporate a return that is based on a risk type other than interest rates. The securitized instruments—the fixed rate bonds with a 7 percent coupon rate and the interest rate swap with fixed payments based on a 7 percent rate and a floating leg based on LIBOR—provide sufficient LIBOR cash flows to satisfy the terms of the beneficial interest. Therefore, the beneficial interest does not contain an embedded derivative that warrants separate accounting under Statement 133.

Example 2

The investor holds a beneficial interest with a payoff equal to a U.S.-dollar denominated fixed-rate bond. The beneficial interest does not incorporate a return that is based on a risk type other than interest rates. The securitized instruments—the EURO-denominated variable-rate corporate bonds and the receive-fixed-U.S. dollar foreign currency interest rate swap—provide sufficient U.S. dollar fixed-rate cash flows to satisfy the terms of the beneficial interest. Therefore, the beneficial interest does not contain an embedded derivative that warrants separate accounting under Statement 133.

Example 3

The investor holds a beneficial interest with a return based on Company ABC common stock. The beneficial interest must be analyzed as a debt host contract. Because the beneficial interest incorporates a return based on equity prices, it contains an embedded feature based on equity prices. That embedded feature permits the investor to participate in fair value changes of Company ABC common stock and incorporates a floor on equity prices that effectively limits the potential loss that would result from a decline in value of Company ABC stock. The embedded equity derivative is not clearly and closely related to the host contract and would require bifurcation.

Example 4

The investor in the senior interest holds a beneficial interest with stated terms that provide for a fixed return. The transferor holds an interest with an equity-based return. Both beneficial interests must be analyzed as debt host contracts. The transferor's interest contains an embedded feature that permits the investor to participate in fair value changes of Company XYZ common stock, after the senior interest is satisfied, plus a purchased floor on equity prices (when the transferor's interest has a fair value of zero) that effectively limits the potential loss that would

result from a decline in value of Company XYZ stock. The embedded equity derivative is not clearly and closely related to the host contract and would require bifurcation. With respect to the investor's senior interest, although the stated terms of the interest indicate a fixed return, the securitized shares of Company XYZ stock may not provide sufficient cash flows to satisfy the stated terms of the interest. Therefore, the investor's interest contains an embedded feature that is a written cap on equity prices equal to the investor's stated fixed return plus a purchased floor on equity prices that effectively limits the potential loss that would result from a decline in value of Company XYZ stock to the amount beyond the loss absorbed by the junior interest. Therefore, the senior interest contains an embedded equity derivative that is not clearly and closely related to the host contract and would require bifurcation.

If a beneficial interest in a qualifying SPE is not a derivative in its entirety and does not contain an embedded derivative that warrants separate accounting under Statement 133, the investor should consider the applicability of paragraphs 14 and 362 of Statement 140 (as amended by Statement 156), which require that interests that continue to be held by the transferor in securitizations in which the holder may not recover substantially all of its recorded investment be subsequently measured like investments in debt securities classified as available-for-sale or trading under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

Effective Date and Transition

The effective date of the revised implementation guidance in this Issue is the first day of the first fiscal quarter beginning after [open]. If an entity had not bifurcated an embedded derivative but is required to do so under the revised guidance, the entity should account for the effects of initially complying with the revised implementation guidance prospectively for all existing beneficial interests whether purchased in a third-party securitization or interests that continue to be held by transferors as of the effective date of this Issue, except for the existing contracts that qualify for the grandfathering provisions of paragraph 50, which exempts certain hybrid instruments from the embedded derivative provisions of Statement 133 on an all-or-none basis. The effects of initially complying with the revised implementation guidance as of the effective date should be reported as a cumulative-effect-type adjustment of net income.

The above response represents a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB and incorporated into an FASB staff implementation guide. The comment period for this Issue ended on July 1, 2002. The FASB plans to consider these issues further in a limited-scope interpretation of FASB Statement 140.