

Title: Embedded Derivatives: Calls and Puts in Debt Instruments
Paragraph references: 12, 13, 61(d)
Date cleared by Board: May 17, 2000
Date latest revision posted to website: June 30, 2005
Affected by: FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
Revised June 29, 2005

QUESTION

When should embedded calls and puts that can accelerate the settlement of debt instruments be considered to be not clearly and closely related to the debt host contract and, thus, be accounted for under the provisions of paragraph 61(d) of Statement 133? Specifically, consider the nine illustrative debt instruments in the attachment that contain calls and puts that can accelerate settlement of the debt.

BACKGROUND

Paragraph 61(d) of Statement 133, as amended by Statement 149, states that calls and puts that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to a debt host contract unless both (1) the debt involves a substantial premium or discount and (2) the put or call option is only contingently exercisable, provided the call options (or put options) are also considered to be clearly and closely related to the debt host contract under paragraph 13. The paragraph goes on to state that for contingently exercisable calls and puts to be considered clearly and closely related, they can be indexed only to interest rates or credit risk, not some extraneous event or factor.

RESPONSE

The following four-step decision sequence should be followed in determining whether calls and puts that can accelerate the settlement of debt instruments should be considered to be clearly and closely related to the debt host contract:

- Step 1: Is the amount paid upon settlement (also referred to herein as the “payoff”) adjusted based on changes in an index (rather than simply being the repayment of principal at par, together with any unpaid accrued interest)? If yes, continue to Step 2. If no, continue to Step 3.
- Step 2: Is the payoff indexed to an underlying other than interest rates or credit risk? If yes, then that embedded feature is not clearly and closely related to the debt host contract and further analysis under Steps 3 and 4 is not required. If no, then that embedded feature should be analyzed further under Steps 3 and 4 as well as under the provisions of paragraphs 12, 13, and 61(a).

Step 3: Does the debt involve a substantial premium or discount? If yes, continue to Step 4. If no, in accordance with paragraph 61(d), further analysis of the contract under paragraph 13 is required to determine whether the call or put is clearly and closely related to the debt host contract.

Step 4: Does a contingently exercisable call or put accelerate the repayment of the contractual principal amount? If yes, the call or put is not clearly and closely related to the debt instrument. If not contingently exercisable, in accordance with paragraph 61(d), further analysis of the contract under paragraph 13 is required to determine whether the call or put is clearly and closely related to the debt host contract.

The attachment demonstrates the application of the guidance in this Issue to nine illustrative debt instruments.

EFFECTIVE DATE

The revisions made on April 9, 2002, emphasize that, in determining whether calls and puts that can accelerate the settlement of debt instruments are clearly and closely related to the debt host contract, analysis under paragraph 13 is required. Those changes affected Step 3 and Example 1. The effective date of the April 9, 2002 revisions to the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after April 10, 2002, the date that the revised Board-cleared guidance was posted to the FASB website. The revisions made on March 26, 2003, and June 29, 2005, do not affect the effective date.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Attachment to Implementation Issue No. B16

Example	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
1. Debt that is issued at a substantial discount is callable at any time during its 10-year term. If the debt is called, the investor receives the par value of the debt plus any unpaid and accrued interest.	No.	Yes.	No.	The embedded call option is clearly and closely related to the debt host contract because the payoff is not indexed to an underlying other than interest rates or credit risk, and the call option is not contingently exercisable.
2. Debt that is issued at par is callable at any time during its term. If the debt is called, the investor receives the greater of the par value of the debt or the market value of 100,000 shares of XYZ common stock (an unrelated company).	Yes, based on an equity price.	N/A. Analysis not required.	N/A. Analysis not required.	The embedded call option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price.

Attachment to Implementation Issue No. B16

Example	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
3. Debt that is issued at par is puttable if the S&P 500 increases by at least 20 percent. If the debt is put, the investor receives the par amount of the debt adjusted for the percentage increase in the S&P 500.	Yes, based on an equity index (S&P 500).	N/A. Analysis not required.	N/A. Analysis not required.	The embedded put option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price.
4. Debt that is issued at a substantial discount is puttable at par if LIBOR either increases or decreases by 150 basis points.	No.	Yes.	Yes, contingent on a movement of LIBOR of at least 150 basis points.	The put option is not clearly and closely related to the debt host contract because the debt was issued at a substantial discount and the put option is contingently exercisable.

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Example	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
5. Debt that is issued at a substantial discount is puttable at par in the event of a change in control.	No.	Yes.	Yes, contingent on a change in control.	The put option is not clearly and closely related to the debt host contract because the debt was issued at a substantial discount and the put option is contingently exercisable.
6. Zero coupon debt is issued at a substantial discount and is callable in the event of a change in control. If the debt is called, the issuer pays the accreted value (calculated per amortization table based on the effective interest rate method).	No.	Yes.	Yes, contingent on a change in control, but since the debt is callable at accreted value, the call option does not accelerate the repayment of principal.	The call option is clearly and closely related to the debt host contract. Although the debt was issued at a substantial discount and the call option is contingently exercisable, the call option does not accelerate the repayment of principal because the debt is callable at the accreted value.

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Example	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
7. Debt that is issued at par is puttable at par in the event that the issuer has an initial public offering.	No.	No	N/A. Analysis not required.	Further analysis under paragraph 13 is required.
8. Debt that is issued at par is puttable if the price of the common stock of Company XYZ (a company unrelated to the issuer or investor) changes by 20 percent. If the debt is put, the investor will be repaid based on the value of Company XYZ's common stock.	Yes, based on an equity price (price of Company XYZ's common stock).	N/A. Analysis not required.	N/A. Analysis not required.	The embedded put option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price.

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Example	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
9. Debt is issued at a slight discount and is puttable if interest rates move 200 basis points. If the debt is put, the investor will be repaid based on the S&P 500.	Yes, based on an equity index (S&P 500).	N/A. Analysis not required.	N/A. Analysis not required.	The embedded put option is not clearly and closely related to the debt host contract because the payoff is based on an equity index.