## Notice for Recipients
## of This Proposed Statement 133 Implementation Issue

This proposed Statement 133 Implementation Issue clarifies that a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of Statement 133 if it meets specified criteria.

The Board invites individuals and organizations to send written comments on all matters in this proposed Statement 133 Implementation Issue. Comments are requested from those who agree with the provisions of this proposed Statement 133 Implementation Issue as well as from those who do not. Comments are most helpful if they identify the issues or specific paragraph or group of paragraphs to which they relate and clearly explain the issue or question. Those who disagree with provisions of this proposed Statement 133 Implementation Issue are asked to describe their suggested alternatives, supported by specific reasoning.

Responses from interested parties wishing to comment must be **received** in writing by **December 8, 2006**. Interested parties should submit their comments by email to "*derivatives@fasb.org*, File Reference: Proposed Issue B40." Those without email may send their comments to "*Larry Smith, Director of Technical Application & Implementation Activities, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116,* File Reference: Proposed Issue B40." 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's website and will be included as part of the public record with other project materials.

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| **Title:** | Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets |
| **Paragraph references:** | 13(b), 14A, 61(a), 61(d) |
| **Date released:** | November 2006 |

## QUESTION

Are there circumstances in which a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of Statement 133?

## BACKGROUND

FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, amended Statement 133 to, among other things, establish a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. As a result, upon the adoption of Statement 155, some securitized financial assets are required to be analyzed in accordance with Statement 133 for the first time. (Previously, holders of beneficial interests in securitized financial assets were not subject to Statement 133 if they elected to apply the guidance in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets.")

Paragraph 14A of Statement 133 (as amended by Statement 155) states:

> The holder of an interest in securitized financial assets (other than those identified in paragraph 14) shall determine whether the interest is a freestanding derivative or contains an embedded derivative that under paragraphs 12 and 13 would be required to be separated from the host contract and accounted for separately. That determination shall be based on an analysis of the contractual terms of the interest in securitized financial assets, which requires understanding the nature and amount of assets, liabilities, and other financial instruments that compose the entire securitization transaction. A holder of an interest in securitized financial assets should obtain sufficient information about the payoff structure and the payment priority of the interest to determine whether an embedded derivative exists.

Paragraph 13 of Statement 133 states:

> For purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:

a. The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover substantially all of its initial recorded investment.*

b. The embedded derivative meets both of the following conditions:

(1) There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate of return on the host contract.

(2) For each of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed under paragraph 13(b)(1)), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under each of those future interest rate scenarios) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer's credit quality at inception.

Even though the above conditions focus on the investor's rate of return and the investor's recovery of its investment, the existence of either of those conditions would result in the embedded derivative instrument not being considered clearly and closely related to the host contract by both parties to the hybrid instrument. Because the existence of those conditions is assessed at the date that the hybrid instrument is acquired (or incurred) by the reporting entity, the acquirer of a hybrid instrument in the secondary market could potentially reach a different conclusion than could the issuer of the hybrid instrument due to applying the conditions in this paragraph at different points in time. [Footnote 6 omitted.]

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* The condition in paragraph 13(a) does not apply to a situation in which the terms of a hybrid instrument permit, but do not require, the investor to settle the hybrid instrument in a manner that causes it not to recover substantially all of its initial recorded investment, provided that the issuer does not have the contractual right to demand a settlement that causes the investor not to recover substantially all of its initial net investment.

Paragraph 61(a) elaborates on the condition in paragraph 13(b) as follows:

An embedded derivative in which the underlying is an interest rate or interest rate index and a host contract that is considered a debt instrument are considered to be clearly and closely related unless, as discussed in paragraph 13, the embedded derivative contains a provision that…could under any possibility whatsoever at least

> double the investor's initial rate of return on the host contract and at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

Paragraph 61(d) of Statement 133 elaborates on the applicability of paragraph 13 to embedded calls and puts in debt instruments as follows:

> Call options (or put options) that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to a debt instrument that requires principal repayments unless both (1) the debt involves a substantial premium or discount (which is common with zero-coupon bonds) 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.

**RESPONSE**

Yes. A securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of Statement 133 if it meets all of the following criteria:

a. The right to accelerate the settlement of the securitized interest cannot be controlled by the investor
b. The underlying financial assets do not contain an embedded derivative that requires bifurcation
c. The securitized interest itself does not contain an embedded derivative (including an interest rate related derivative) for which bifurcation would be required other than an embedded derivative that results solely from the embedded call options in the underlying financial assets.

The objective of this guidance is to provide a narrow scope exception from paragraph 13(b) of Statement 133 for securitized interests that contain **only** an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets and that meets the criteria above. If a securitized interest contains any other terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument and those terms create an embedded derivative that requires bifurcation (ignoring the effects of the embedded call options in the underlying financial assets), those securitized interests would be subject to the requirements of paragraph 13(b) of Statement 133 (for example, an inverse floater).

Determining whether the underlying financial assets contain an embedded derivative that requires bifurcation will require an understanding and assessment of the nature of the assets that collateralize the securitization. This assessment is expected to be simple for basic securitized interests but could be more difficult for complex securitized interests (for example, when some or all of the assets that provide cash flows to the securitization are themselves securitized interests, because the investor is required to assess whether the underlying securitized interests contain embedded derivatives, which would require an analysis of the financial assets and liabilities that provide cash flows to the underlying securitized interests).

The inclusion of a freestanding derivative instrument as an asset or liability that collateralizes the securitization does not affect the analysis of condition (b) of this Issue. However, it is possible that such a freestanding derivative could result in the securitized interest itself containing an embedded derivative that requires bifurcation and, therefore, failing condition (c) of this Issue.

A securitized interest that does not meet all of the criteria above is subject to the conditions in paragraph 13(b) of Statement 133. When assessing the conditions in paragraph 13(b) for those instruments, an entity must consider the effect of prepayment risk.

Application of this guidance to specific securitized interests in prepayable financial assets is provided below. The analysis of the examples considers only paragraph 13(b) of Statement 133, which is the subject of this Issue. The examples provide no consideration of the requirements of paragraph 13(a) of Statement 133, even if those requirements are applicable to the instruments in the examples.

| Example | Application of This Guidance |
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| <u>1. Guaranteed Single-Class Mortgage Pass-Through Security</u><br>A fixed-rate MBS is issued, whereby the net cash flows received on the underlying fixed-rate, prepayable, single-family mortgage loans are proportionately passed through to the MBS investors. Both the interest and principal payments are guaranteed by a third party for a fixed market-based guarantee fee and a servicer receives a market-based servicing fee that is in excess of adequate compensation. Both the guarantee fee and the servicing fee have priority over the payments to the MBS investors. Additionally, the investor does not have the right to accelerate the settlement of the securitized interest and the underlying financial assets do not contain an embedded derivative that requires bifurcation. | While the priority of cash flows to the guarantor and servicer results in disproportionate allocation, the example security meets the three criteria.<br><br>**Conclusion:** Paragraph 13(b) is not applicable to the guaranteed single-class mortgage pass-through security. |

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| <u>2. Securitization Trust Includes a Freestanding Derivative</u><br>Assume the same facts as presented in Example 1, except that the underlying prepayable single-family mortgage loans have a floating interest rate. The securitization trust also holds an interest rate swap that is designed to perfectly swap the floating interest rate assets to a fixed interest rate to match the payments on the fixed-rate MBS. | Because the addition of the freestanding derivative (the interest rate swap) does not create an embedded derivative that requires bifurcation in the MBS itself, the example security meets the three criteria.<br><br>**Conclusion:** Paragraph 13(b) is not applicable to the MBS. |
| <u>3. Sequential-Pay Collateralized Mortgage Obligation (CMO)</u><br>An entity securitizes a pool of guaranteed single-class mortgage pass-through securities (identical to those described in Example 1). The principal payments received, including prepayments of principal, on the underlying collateral are not allocated proportionately to all investors (bond holders). Three classes of securities are issued, Class A, Class B, and Class C, which mature sequentially. All three classes participate in interest payments from the underlying collateral, but initially, only Class A receives principal payments. Class A receives all principal payments, including prepayments of principal, until it is retired. Next, all principal payments are paid to Class B until it is retired, and so on. Additionally, the investor does not have the right to accelerate the settlement of the securitized interest and the underlying financial assets do not contain an embedded derivative that requires bifurcation. | The analysis of the bonds requires the holder to assess the securitized interest in accordance with condition (b) of this issue. To determine whether the underlying financial assets contain an embedded derivative that requires bifurcation, the investor would have to analyze the financial assets and liabilities that provide cash flows to each of the securitized guaranteed single-class mortgage pass-through securities. As it is assumed that those mortgage pass-through securities are identical to those described in Example 1 and that the underlying financial assets do not contain any other embedded derivatives that require bifurcation, condition (b) of this issue is met.<br><br>While the prepayment risk in the underlying financial assets is reallocated through the securitization process, concentrating prepayment risk in certain bond classes, all three classes in the example meet the three criteria.<br><br>**Conclusion:** Paragraph 13(b) is not applicable to any of the bond classes in the sequential-pay CMO. |

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| <u>4. Planned Amortization Class (PAC) / Companion CMO</u><br>An entity securitizes a pool of guaranteed single-class mortgage pass-through securities (identical to those described in Example 1). The principal payments received, including prepayments of principal, on the underlying collateral are not allocated proportionately to all investors (bond holders). Two classes of securities are issued, a PAC bond and a companion bond. The PAC bond is designed to reduce the prepayment risk to investors by transferring prepayment risk to the companion bond. The PAC bond offers a fixed principal repayment schedule that will be met if prepayment on the underlying collateral is within a specified range. Additionally, the investor does not have the right to accelerate the settlement of the securitized interest and the underlying financial assets do not contain an embedded derivative that requires bifurcation. | The analysis of the bonds requires the holder to assess the securitized interest in accordance with condition (b) of this issue. To determine whether the underlying financial assets contain an embedded derivative that requires bifurcation, the investor would have to analyze the financial assets and liabilities that provide cash flows to each of the securitized guaranteed single-class mortgage pass-through securities. As it is assumed that those mortgage pass-through securities are identical to those described in Example 1 and that the underlying financial assets do not contain any other embedded derivatives that require bifurcation, condition (b) of this issue is met.<br><br>While the prepayment risk in the underlying prepayable financial assets is reallocated through the securitization process, concentrating prepayment risk in the companion bond, the example securities meet the three criteria.<br><br>**Conclusion:** Paragraph 13(b) is not applicable to either the PAC or the companion CMO. |

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| <u>5. Inverse Floater CMO</u><br>A CMO is issued with a coupon that fluctuates inversely with a referenced rate. The underlying securitized financial assets are fixed-rate, prepayable, single-family mortgage loans. Two classes of securitized interests are issued, one with a coupon based on a referenced rate (for example, LIBOR) and the second with a coupon that fluctuates inversely with that same referenced rate (the inverse floater CMO). Cash flows received on the underlying collateral are first used to pay a servicer a market-based servicing fee that is in excess of adequate compensation. Additionally, the investor does not have the right to accelerate the settlement of the securitized interest and the underlying financial assets do not contain an embedded derivative that requires bifurcation. | While the inverse floater CMO meets conditions (a) and (b) of this Issue, the fact that the coupon rate fluctuates inversely with the referenced rate results in the instrument failing condition (c) of this Issue. The inverse floater contains an embedded interest rate derivative that requires bifurcation and that embedded interest rate derivative does not result solely from the embedded call options in the underlying financial assets. Said another way, the inverse floater meets the conditions of paragraph 13(b) without consideration of the prepayment risk in the underlying mortgage loans.<br><br>**Conclusion:** Paragraph 13(b) would be applicable to the inverse floater. When assessing the conditions in paragraph 13(b), the holder must consider the effect of prepayment risk. Therefore, the holder may identify both an embedded derivative related to the prepayment risk and an embedded derivative related to the inverse interest rate risk. |

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| <u>6. Interest-Only Strip and Principal-Only Strip</u><br>An interest-only and principal-only strip is created by separating the net interest cash flows from the principal cash flows received on a pool of guaranteed single-class mortgage pass-through securities (identical to those described in Example 1). The interest cash flows form one bond, which is the interest-only strip. The principal cash flows form the second bond, which is the principal-only strip. Additionally, the investor does not have the right to accelerate the settlement of the securitized interest and the underlying financial assets do not contain an embedded derivative that requires bifurcation. | As a result of the guarantee fee and the excess servicing fee in the underlying guaranteed single-class mortgage pass-through securities, neither the interest-only strip nor the principal-only strip qualify for the scope exception in paragraph 14.<br><br>The analysis of the interest-only and principal-only strip requires the holder to assess the securitized interest in accordance with condition (b) of this issue. To determine whether the underlying financial assets contain an embedded derivative that requires bifurcation, the investor would have to analyze the financial assets and liabilities that provide cash flows to each of the securitized guaranteed single-class mortgage pass-through securities. As it is assumed that those mortgage pass-through securities are identical to those described in Example 1 and that the underlying financial assets do not contain any other embedded derivatives that require bifurcation, condition (b) of this issue is met.<br><br>While the prepayment risk in the underlying prepayable financial assets is reallocated through the securitization process, concentrating prepayment risk in certain bond classes, both the interest-only strip and principal-only strip in the example meet the three criteria.<br><br>**Conclusion:** Paragraph 13(b) is not applicable to either the interest-only strip or the principal-only strip. Analysis under paragraph 13(a) is required for the interest-only strip. |

## EFFECTIVE DATE AND TRANSITION

The guidance in this Issue shall be applied upon initial adoption of Statement 155. An entity that adopted Statement 155 prior to December 31, 2006 shall apply the guidance in this Issue in the first reporting period beginning before December 31, 2006 for which financial statements have not yet been issued.

If an entity had previously adopted Statement 155 and, in doing so, had treated derivatives embedded in a securitized interest in prepayable financial assets in a manner consistent with the guidance in this Issue, then that entity would not be required to retrospectively apply the guidance in this Issue to prior periods. However, if that entity had not treated derivatives embedded in a securitized interest in prepayable financial assets in a manner consistent with the guidance in this Issue, then that entity shall apply the guidance as follows:

a. For entities that previously identified embedded derivatives that would otherwise be included in the scope exception and elected to measure the entire hybrid instrument at fair value, the guidance in this Issue shall be applied retrospectively. In applying this guidance retrospectively, the entity may elect any appropriate classification in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, for the hybrid financial instrument.
b. For entities that previously identified and bifurcated embedded derivatives that would otherwise be included in the scope exception, the guidance in this Issue shall be applied retrospectively. In applying this guidance retrospectively, the entity shall reverse the changes in the fair value of the embedded derivative that were previously recorded in income. The combined instrument shall be recorded, both initially and subsequently, based on the Statement 115 classification previously elected for the host instrument.

## ALTERNATIVE VIEW

One Board member does not agree with providing a "prepayment" exception for deciding when an embedded derivative is considered to be not clearly and closely related to the host instrument. That Board member believes that the guidance in paragraph 13 should be applied to determine whether an embedded derivative is to be bifurcated and either accounted for separately under Statement 133 or accounted for under the option provided by Statement 155 of carrying the combined host and embedded derivative at fair value with changes reported in net income. One of the objectives of Statement 155 was to eliminate the scope exception in Statement 133 Implementation Issue No. D1, "Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," for evaluating securitized beneficial interests for embedded derivatives. This proposed Statement 133 Implementation Issue effectively reinstates this exception for a large number of securitized interests. The shifting of prepayment risk is one of the most common features of securitization of prepayable financial assets and this shifting of prepayment risk creates a significant embedded derivative that otherwise could meet the criteria for bifurcation. The tests in paragraph 13 were established in Statement 133 to provide a mechanical test for making an otherwise difficult judgment concerning whether the embedded derivative is to be accounted for as a derivative. This type of test was requested by many auditors and preparers. The proposed reaction to applying the test some eight years after it was established based on the unpopularity of having to apply the test and the potential result of its application is not appropriate.

*The above response represents a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB. Constituents should send their comments, if any, to Larry Smith, Director of Technical Application & Implementation Activities, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116 (or by e-mail to derivatives@fasb.org) by December 8, 2006.*

## Appendix A: IMPACT ON STATEMENT 133 IMPLEMENTATION ISSUES

This appendix addresses the impact of the provisions of this Statement 133 Implementation Issue on the responses to other Statement 133 Implementation Issues through October 31, 2006.

Statement 133 Implementation Issue No. B39, "Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor," is amended as follows [deletions are ~~struck out~~ and additions are underlined]:

a. The "Paragraph 13(b) Applicable to the Embedded Call Option" section of Example 6 in the chart illustrating the guidance to specific debt instruments:

> ~~No, unless the impacts of the embedded call feature are disproportionately allocated to interest holders~~ Not Applicable (see comments).

b. The "Comments" section of Example 6 in the chart illustrating the guidance to specific debt instruments:

> ~~While the MBS itself does not contain an embedded call option, the Board decided as part of FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments, that an interest in MBS with underlying assets containing an embedded call feature, for which all of the associated cash flows are proportionately passed through to all the interest holders, will not be subject to the conditions in paragraph 13(b) with respect to that embedded call feature. However, in situations in which the cash flows associated with the embedded call feature are disproportionately allocated to different classes of interest holders, all interests in that MBS would be subject to the conditions in paragraph 13(b) with respect to that embedded call feature.~~ Although the related mortgage loans are prepayable, and thus each contain a separate embedded call option, the MBS itself does not contain an embedded call option. While the MBS investor is subject to prepayment risk, the MBS issuer has the obligation (not the option) to pass through cash flows from the related mortgage loans to the MBS investors. Therefore, MBS are not within the scope of this Issue. Issue B40 addresses the application of paragraph 13(b) to securitized interests in prepayable financial assets.