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***SFAS 155 Implementation Issue: FASB Agrees to Expose a Proposed Scope Exception for Certain Securitized Interests in Prepayable Financial Assets***

At the Financial Accounting Standards Board ("FASB" or "Board") meeting ("Meeting") on October 25, 2006, the FASB approved a proposed narrow scope exception for certain beneficial interests that require an embedded derivative analysis. The issue is not whether the beneficial interests contain an embedded derivative, but when the embedded derivative is required to be separately accounted for in accordance with SFAS 133. The Board directed the FASB Staff to prepare an exposure draft for a 30 day comment period with the expectation that final guidance in the form of a SFAS 133 Implementation Issue will be issued in the first quarter of 2007, before reporting deadlines for periods ending December 31, 2006.

**Background**

In February 2006, the FASB issued SFAS 155, *Accounting for Certain Hybrid Financial Instruments* ("SFAS 155"), which, among other things, aimed to clarify certain issues regarding embedded derivatives in financial instruments. Since then, constituents have raised concerns to the Board regarding the application of paragraph 13(b) (the "double-double test") of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"), to beneficial interests that must be evaluated for embedded derivatives pursuant to SFAS

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155. Specifically, the Board received extensive feedback related to discount mortgage-backed securities (“MBS”) and asset-backed securities (“ABS”) subject to prepayment.

In the Meeting, the Board supported the FASB Staff's ("Staff") recommendations related to a proposed narrow scope exception for beneficial interests that:

- **Only contain** an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets; and
- The investor **does not** control the right to accelerate the settlement.

For example, an investor’s risk in a single-class pass-through mortgage backed security issued by a government sponsored entity would be the risk of prepayments on the underlying mortgage loans. Typically, the investor in the security described above does not control the right to accelerate settlement. The Staff’s proposed exemption would not require the investor in such security to analyze the embedded derivative solely related to prepayment risk under paragraph 13(b) of SFAS 133 to determine whether the embedded derivative requires bifurcation.

***SFG Observation:** The issue regarding the analysis of the embedded prepayment option (most notably, in the situation where the beneficial interest was issued/purchased at a discount) has been the subject of extensive debate since the issuance of SFAS 155. Constituents were concerned that FAS 155 would require bifurcation of an embedded derivative related to prepayment of the underlying loans in certain MBS/ABS securities. The impact of SFAS 155 was perceived to be very broad, and arguably affected what many market participants considered to be simple investments.*

The Staff proposed and the Board approved the following language for a scope exception to paragraph 13(b) of SFAS 133:

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

- a. The right to accelerate the settlement of the securitized interest can not be exercised by the investor,
- b. The underlying financial assets do not contain an embedded derivative that requires bifurcation, and
- c. The securitized interest itself does not contain an embedded derivative that requires bifurcation (including an interest rate related derivative), which is not solely related to the reallocation of prepayment risk inherent in the underlying financial assets.

**SFG Observation:** *The proposed scope exception provides relief for principal-only strips created in certain securitization transactions, including in cases where there are payments for guarantee fees and servicing in excess of adequate compensation. However, interest-only strips would not be subject to the proposed scope exception and need to be analyzed for embedded derivatives.*

*While the proposed **non-optional** scope exception provides a clarification on the application of a certain aspect of SFAS 155, the scope exception would still require an understanding and analysis of the securitization transaction. For example, the application of criterion (b) will require a look through to the underlying financial assets. For criterion (c), the existence of any other embedded derivative (other than an embedded derivative tied to the prepayment risk of the underlying assets) would require a full evaluation of the securitized interest under SFAS 133/155.*

### **Next step**

The FASB will expose the proposed scope exception for a 30-day comment period, allowing constituents to provide feedback on the proposal. Following the comment period, the Board is expected to begin re-deliberations in mid-December. It is expected that final guidance, in the form of a SFAS 133 Implementation Issue, will be issued in early 2007, prior to most reporting deadlines for periods ending December 31, 2006.

**SFG Observation:** *The Board understood the concerns raised by constituents regarding the prepayment option issue. Most Board members believe the acceptance of the Staff's recommendations will address the most significant concerns.*

*For entities that early adopted SFAS 155 and did not bifurcate embedded derivatives that would be included under the proposed scope exception, no transition provisions are required. For entities that elected to bifurcate derivatives or apply the fair value option, the exposure draft will provide transition guidance.*

For further information on SFAS 155, please read the DataLine 2006-5 (click: [here](#)) and DataLine 2006-27 (click: [here](#)), which summarize the provisions of SFAS 155 and provide PwC's insights. The Board Meeting Handout can be accessed at this web-link (click: [here](#)).

## Questions

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