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SFAS 155 Implementation Issue: FASB agrees to remove "look-through" concept of proposed DIG Issue B40 and to delay the effective date for the application of criterion (c) for certain immaterial embedded derivatives.

At the Financial Accounting Standards Board ("FASB" or "Board") meeting ("Meeting") on December 20, 2006, the FASB agreed by a narrow margin to remove criterion (b) and delay the effective date of criterion (c) of the proposed DIG Issue B40, which provides certain beneficial interests with a scope exception from the requirement to perform an embedded derivative analysis. (Refer to Attachment 1 for excerpts from the Proposed DIG Issue B40.)

Background

On November 7, 2006, the FASB issued the proposed DIG Issue B40 (with an accelerated 30-day public comment period). Proposed DIG Issue B40 provides an exception to the application of paragraph 13(b) of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"), if a securitized interest in prepayable financial assets 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, and

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- 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.

Proposed DIG Issue B40 was intended to provide a narrow scope exception from paragraph 13(b) of SFAS 133 for securitized interests that contain only an embedded derivative that results from the prepayment risk of the underlying prepayable financial assets. Securitized interests that contain other terms that create an embedded derivative would be subject to the requirements of paragraph 13(b) (e.g., an interest rate feature such as an inverse floater).

The FASB issued proposed DIG Issue B40 to address constituents concerns about the application of paragraph 13(b) (the "double-double" test) to even the simplest securities purchased at a discount as required by SFAS 155, *Accounting for Certain Hybrid Financial Instruments* ("SFAS 155").

Literal application of the 13(b) test may have led to the bifurcation of an embedded prepayment option in the underlying financial assets even when the outcome was the result of an extremely remote prepayment scenario that increased the security's return to a level that exceeded the "double-double" test thresholds.

Comment Letters

The FASB received 18 comment letters on the proposed DIG Issue B40. A majority of respondents agreed with the objectives of the proposed DIG Issue B40. However, a majority of the respondents also noted that the proposed guidance would not provide relief for a significant number of securitized interests and that the guidance did not meet the intended objectives of the project. Respondents mainly were concerned with criteria (b) and (c) above.

Criterion (b) of the proposed DIG Issue B40 would have created a "look-through" requirement as part of the evaluation of the underlying collateral. The proposed scope exception would have provided relief to single class agency pass through securities; however, many constituents believed that criterion (b) created requirements that would have been particularly onerous and inconsistent with the original intent of SFAS 155.

Multiple respondents indicated that it would be difficult to analyze all the assets that support each securitized interest. Additionally, although the "look-through" was intended to discourage structuring designed to avoid derivative accounting, it

also would have resulted in certain securitizations and re-securitizations being excluded from the proposed scope exception.

Respondents also noted that the requirement that the underlying financial assets do not contain an embedded derivative that requires bifurcation is inconsistent with the provision that freestanding derivatives held by the securitization trust are permissible. Finally, the respondents noted that criterion (b) was not needed because criterion (c) would capture the effects of any derivative embedded in the collateral.

SFG Observation: *Under the proposed DIG Issue B40, investors would have been required to evaluate each attribute of the underlying collateral in a securitization to determine whether any embedded derivatives required bifurcation. The magnitude of this exercise and the lack of availability and access to the required information were raised as concerns by many respondents.*

Respondents also noted that an immaterial embedded derivative, such as one that meets paragraph 13(a) of SFAS 133, would preclude the application of the scope exception to the particular securitized interest. Respondents noted that a significant amount of securitized interests contain immaterial embedded derivatives that would require bifurcation under criterion (c).

Board Decisions

Based upon review of the comment letters, the FASB Staff ("Staff") believed that revisions to the proposed DIG Issue B40 were needed to meet the objectives of the project. At the FASB meeting on December 20, 2006, the Board agreed to the Staff's recommendation to:

- 1) remove criterion (b), and
- 2) retain criterion (c) with a delayed effective date.

An instrument would not be subject to this criterion if:

- (1) it was issued before June 30, 2007, and
- (2) the other embedded derivative which requires bifurcation is immaterial or has a fair value of zero at the effective date of SFAS 155.

The Board asked the Staff to perform further research on the sufficiency of the six month time frame selected for the delayed effective date and include their conclusions in the ballot draft of DIG Issue B40.

The Board also agreed to the Staff's recommendation to make a number of editorial changes based on several respondents' comments.

SFG Observation: *The reason for the delayed effective date was that several embedded features, particularly those driven by extremely remote interest rate scenarios, would cause the loss of initial net investment under criterion 13(a) of SFAS 133. The existence of an immaterial derivative would then trigger the evaluation of the embedded prepayment option under 13(b) and would prevent the investor from applying the proposed scope exception.*

Some structures contain certain risks, for example, insignificant basis risk between the collateral and the beneficial interest issued by the entity, that typically would not have a material consequence to investors, but would require bifurcation under paragraph 13 of SFAS 133.

Many investors in securitized assets prefer securities that do not contain derivative features. The delayed effective date will provide issuers with additional time to change their structures to eliminate or modify any immaterial derivative features. Newly created structures can be modified to include caps or floors that would provide investors relief from bifurcating immaterial embedded derivatives, thereby retaining their ability to apply the scope exception in proposed DIG Issue B40.

At the FASB meeting, certain Board members acknowledged the broader practice issues with paragraph 13 of SFAS 133, such as how the paragraph 13(b) test could be failed only in extremely remote scenarios.

One Board member suggested that the FASB consider delaying the implementation of SFAS 155, par. 14A (effectively reinstating DIG Issue D1) until the Board could further discuss the fundamental issues of paragraph 13 of SFAS 133. While other Board members acknowledged the benefits of the suggested approach, there was not enough support for this proposal.

Next Steps

The FASB expects to issue a final DIG Issue B40 by mid January 2007 to give investors sufficient time to comply with the effective date of SFAS 155.

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

Questions regarding this Advisory may be directed to:

Jeff Allen (646-471-2937), Frederick (Chip) Currie (646-471-3661), Neal Dykes (646-471-2359), Frederick Elmy (646-471-2830), Norman Leung (646-471-0521), Sam May (646-471-2357), and Frank Serravalli (646-471-2669).

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Excerpts from Proposed DIG Issue B40

A securitized interest in pre-payable 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.