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Amendment of FASB Interpretation No. 39

Summary

In December, the Financial Accounting Standards Board ("FASB" or the "Board") released a proposed FASB Staff Position, "Amendment of FASB Interpretation No. 39" ("Proposed FSP"), for public comments.

The Proposed FSP makes certain modifications to FASB Interpretation No. 39, "Offsetting of Amounts related to Certain Contracts" ("FIN 39") and addresses offsetting receivables or liabilities recognized upon payment or receipt of cash collateral arising from master netting derivative arrangements.

SFG Observation: The Proposed FSP permits the offsetting of receivables or liabilities recognized upon payment or receipt of cash collateral against net derivative positions with counterparties pursuant to a master netting agreement.

Background

Most counterparties to derivative transactions enter into master netting arrangements to manage credit risk. In the event of a counterparty default, a master netting agreement allows settlement of all covered contracts on a net basis.

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SFG Observation: An enforceable master netting agreement prevents a non-defaulting party from settling derivative liability positions before it receives payments from the defaulting counterparty on its asset positions. Absent the netting agreement, the non-defaulting counterparty would be in a similar position with other creditors to collect on its derivative asset positions.

A credit support annex ("CSA") is often included as a component of a master netting agreement. A CSA enables a counterparty to require the other counterparty to post collateral against its net liability position. The collateral is generally cash, high-quality securities, or letters of credit.

SFG Observation: The party who posts cash collateral records a receivable for the right to receive a return of that cash collateral. The party who receives the cash collateral records the cash and a liability for the obligation to return the cash collateral.

The Netting Requirements of FIN 39

FIN 39 requires all four criteria to be met for net presentation:

- 1) Each of two parties owes the other determinable amounts.
- 2) The reporting party has the right to set off the amount owed with the amount owed by the other party.
- 3) The reporting party intends to set off.
- 4) The right of setoff is enforceable at law.

Application of FIN 39 to Derivative Contracts

FIN 39 provides an exception to the requirements for netting of derivative asset and liability positions subject to a master netting agreement. Specifically, counterparties can net derivative asset and liability positions that are subject to master netting arrangements even if they have no intent to set off.

FIN 39, however, does not explicitly address whether receivables recognized for the right to receive posted cash collateral or liabilities recognized for the obligation to return cash collateral can be offset against net derivative exposures.

SFG Observation: According to Statement of Financial Accounting Standards 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" ("SFAS 140"), a transfer of non-cash collateral does not trigger a receivable and a liability except when the secured party records an obligation to return collateral that it has sold to another party.

The proposed FSP does not address non-cash collateral.

Proposed FSP

The absence of explicit guidance in FIN 39 related to netting cash collateral posted pursuant to CSAs has resulted in diversity in practice. Some derivative parties have concluded that:

- 1) The receivables and liabilities related to cash collateral arise from conditional contracts as defined in FIN 39; and
- 2) The amount posted under the CSA is a fair value amount.

In the November 29, 2006 Board meeting, supporters of the view that receivables and liabilities associated with cash collateral can be used to offset derivative positions expressed the following views:

- 1) CSAs are conditional contracts. The obligations and rights related to CSAs are dependant upon market conditions, such as changes in interest rates or other underlyings, that determine the value of the derivative positions subject to the master netting agreement;
- 2) Collateral posted is adjusted to reflect the current fair value of derivative positions; and
- 3) The CSA is an integral part of the master netting agreement.

Some Board members did not support the Proposed FSP and expressed the following views in the meeting:

- 1) CSAs are not conditional contracts because the obligations and rights related to CSAs are not dependant upon market conditions but are instead dependant upon an occurrence of default; and
- 2) CSAs are not always accounted for at fair value because they lack a fair value measurement attribute.

In December, the Board released the Proposed FSP for public comments. The Proposed FSP allows receivables or liabilities recognized upon payment or receipt of cash collateral in accordance with master netting arrangements to offset related net derivative positions. If counterparties elect to net their derivative asset and liability positions pursuant to master netting arrangements, cash collateral recognized at fair value must also be netted.

The Board clarified the term conditional or exchange contracts used in FIN 39 by replacing it with the term “derivative instruments” as defined in Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments

and Hedging Instruments". The Board also specified that if cash collateral receivables and payables are recognized at fair value, they can be netted with derivatives arising from the same master netting agreement.

SFG Observation: The conclusion reached by the Board in the Proposed FSP ensures the consistent application of FIN 39 by requiring net derivative positions shown on the balance sheet to include posted cash collateral recognized at fair value. However, non-cash collateral is not included in net derivative positions shown on the balance sheet.

Readers of the financial statements will need to assess credit risk to derivative counterparties by combining the net derivative exposure with posted non-cash collateral. The amount of posted non-cash collateral is a required disclosure pursuant to SFAS 140.

In its Derivative Disclosures Project, the Board tentatively decided to exclude receivables and liabilities arising from CSAs from the disclosures of derivative positions because

- 1) Including them may mislead investors as to what risks are being hedged and the related net exposure, and
- 2) CSAs are not within the scope of the Derivative Disclosures Project.

Consequently, users of financial statements should be able to identify the gross exposure of a derivative counterparty.

Next step

The FASB exposed the Proposed FSP for a 45-day comment period which ends January 31, 2007. It is expected that the final FASB Staff Position will be issued in early 2007.

Questions

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