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SFAS 133 Implementation Issue B40: Embedded Derivatives: Application of Paragraph 13(b) to Securitize Interests in Prepayable Financial Assets

The Financial Accounting Standards Board (FASB) recently released Statement 133 Implementation Issue No. B40, “Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets” (DIG Issue B40).

DIG Issue B40 provides a narrow scope exception for certain securitized interests from the interest rate related embedded derivative tests required under paragraph 13(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133). Those tests are commonly referred to in practice as the “double-double” test.

DIG Issue B40 represents the culmination of the FASB staff’s consideration of the need for further guidance for securitized interests following the issuance in February 2006 of FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140* (FAS 155).

SFG Observation: *DIG Issue B40 provides additional guidance for how to assess potential embedded derivatives.*

An entity that adopted FAS 155 prior to December 31, 2006 shall apply the new guidance in the first reporting period beginning before December 31, 2006 for which financial statements have not yet been issued. As such, calendar-year-entities that early adopted FAS 155 are required to assess the need to adjust their 2006 financial statements based on the new implementation guidance.

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Background

FAS 155 nullified the guidance in FAS 133 Implementation Issue No. D1, “*Application of Statement 133 to Beneficial Interests in Securitized Financial Assets*,” which deferred the application of the bifurcation requirements of FAS 133 for certain securitized interests.

FAS 155 requires securitized interests to be analyzed to determine whether such instruments are:

1. freestanding derivatives in their entirety; or
2. hybrid financial instruments that contain embedded derivatives requiring bifurcation.

Specifically, FAS 155 requires an analysis of the contractual terms of the securitized interest. The analysis generally requires an understanding of the nature and amount of assets, liabilities, and other financial instruments that compose the entire securitization transaction.

The embedded derivatives analysis also requires information about the payoff structure and the payment priority of the securitized interest to determine whether such interest contains an embedded derivative requiring bifurcation.

SFG Observation: *Concentration of credit risk in the form of subordination of one financial instrument to another and changes in the cash flows attributable to changes in the creditworthiness of an interest in securitized financial assets and liabilities are not considered to be embedded derivatives.*

Analysis of Securitized Interest

A securitized interest is within the scope of FAS 133 if it meets one of the following criteria:

1. The definition of a derivative in its entirety;
2. Explicit contractual terms of the securitized interest clearly indicate an embedded derivative feature; or
3. Cash flows generated by the financial assets and derivatives of the securitization entity might not support the terms of the securitized interest (i.e., there could be a shortfall in cash), assuming that they perform pursuant to their contractual terms. For purposes of this analysis, credit losses from the counterparty of such assets and derivatives are not considered.

SFG Observation: *The definition of a derivative is set forth in FAS 133, paragraph 6:*

A derivative instrument is a financial instrument or other contract with all three of the following characteristics:

a. It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both.

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Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required. [DIG Issue A6]

b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. [DIG Issue A1]

c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement. [DIG Issues: A3, A5, A8, A10, A13, A17, and B25]

If the securitized interest contains an embedded derivative feature based upon either criterion 2 or 3 above, the embedded derivative must be separated from the host contract and accounted for as a derivative (i.e., bifurcated) pursuant to paragraph 12 of FAS 133 unless the entity elects to measure the hybrid financial instrument in its entirety at fair value under FAS 155.

Derivative accounting is required when:

1. A separate instrument with the same terms as the embedded derivative would be considered a derivative within the scope of FAS 133;
2. The hybrid financial instrument is not re-measured at fair value with changes recorded in earnings under otherwise applicable accounting guidance; or
3. The embedded derivative is not clearly and closely related to the host contract. The concept of clearly and closely focuses on whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract.

SFG Observation: *We expect many entities that identify embedded derivatives requiring bifurcation to elect the fair value option.*

Evaluating Interest Rate Derivatives

An embedded derivative with an interest rate underlying is not clearly and closely related to the host contract if either of the following conditions in FAS 133, paragraph 13 exist:

Recovering an Initial Investment

- 13(a) The hybrid financial instrument can contractually be settled in a way that the investor would not recover substantially all of its initial investment; or

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Doubling the Interest Rate Return

13(b) A possible interest-rate scenario exists that could

- at least double the investor's initial rate of return on the host contract, and
- for each of the possible interest-rate scenarios under which the rate of return could be doubled, the embedded derivative would also result in a rate of return that is at least twice what otherwise would be the then-current market return.

SFG Observation: *If the embedded derivative identified under FAS 155 meets the requirements outlined in paragraphs 12 and 13 of FAS 133, the securitized interest would be considered a hybrid financial instrument.*

The hybrid instrument should be bifurcated into a host contract, and a derivative. Alternatively, FAS 155 provides an option to measure the entire hybrid financial instrument at fair value with changes in fair value reflected in earnings.

The DIG Issue B40 Exception

DIG Issue B40 provides a narrow scope exception from the tests required under paragraph 13(b) of FAS 133 for securitized interests that contain an embedded derivative that is tied to the prepayment risk of the underlying pre-payable financial asset.

The exception applies when:

- a. The right to accelerate the settlement of the securitized interest cannot be controlled by the investor; and

SFG Observation: *Prepayment features typically cannot be controlled by the investor. In many securitized financial instruments, the investor does not have the option to accelerate payment of its principal.*

- b. 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 (when applicable as described below).

SFG Observation: *The securitized interest must be analyzed to determine whether there are other derivative-like features that arise without consideration of the prepayment risk that exists in many securitized interests. For example, some securitized interests contain an embedded interest rate swap, cap or floor. These features need to be assessed to determine whether they are clearly and closely related.*

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Effective Dates

DIG Issue B40 is required to be applied upon adoption of FAS 155. Criterion (b) is not applicable to securitized interests that:

- (1) were issued before June 30, 2007; and
- (2) only include embedded derivatives, other than an embedded derivative that results solely from embedded call options in the underlying financial assets that have an extremely remote possibility of having greater than a trivial fair value at any time during the instrument's life.

The assessment is required upon adoption of FAS 155 or the purchase of the instrument, whichever occurs later, and does not apply to an embedded derivative that results solely from the embedded call options in the underlying financial assets.

SFG Observation: *For example, an embedded derivative that only has value when an interest rate index reaches a rate level that would only occur with low probability or in remote circumstances may meet criterion 2.*

The determination of whether a securitized interest was issued before June 30, 2007 is straight forward. For example, a securitized interest acquired by an entity in August 2007 that was originally issued in January 2007 would be considered to have been issued before June 30, 2007.

When, as a result of applying the transition guidance in DIG Issue B40 retrospectively, an entity must recombine a host instrument with a previously bifurcated embedded derivative, any changes in the fair value of the embedded derivative that were previously recorded in income must be reversed.

Transition Guidance for Entities That Early Adopted FAS 155

The guidance in DIG Issue B40 requires retrospective application to the date of adoption of FAS 155.

All entities that early adopted FAS 155 must now evaluate securitized interests in a manner consistent with the guidance in DIG Issue B40.

SFG Observation: *Entities that early adopted FAS 155 in 2006 will need to reconsider their bifurcation analyses (under paragraph 13 of FAS 133) of securitized interests issued, acquired, or subject to a re-measurement (new basis) event during the year of adoption. (For example, 2006 in the case of calendar year-end entities that early adopted FAS 155.)*

Calendar year-end entities that early adopted FAS 155 may need to make adjustments to their 2006 year-end financial statements to comply with DIG Issue B40.

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Judgment will need to be applied to assess whether a derivative has more than an extremely remote possibility of having greater than a trivial fair value over the life of the instrument. The determination should be made on the date of adoption of FAS 155, or the date of purchase of the securitized interest, whichever occurs later.

The evaluation of extremely remote or trivial will depend on the specific facts and circumstances of the transaction.

The assessment of whether an embedded derivative has a trivial fair value should consider the:

- 1. fair value of the embedded derivative relative to the total fair value of the securitized interest;*
- 2. current fair value of the embedded derivative; and*
- 3. potential variability of the fair value of the embedded derivative over its life.*

No bifurcation analysis is necessary for securitized interests acquired prior to the adoption of FAS 155. FAS 155 requires prospective application to securitized interests issued, acquired, or subject to a re-measurement (new basis) event after the date of adoption.

SFG Observation: *The guidance in FAS 155 and DIG Issue B40 does not need to be applied to interests acquired before adoption of FAS 155. If there is a new basis event, however, the securitized interest will need to be evaluated under these standards.*

A re-measurement (new basis) event is an event identified in authoritative accounting literature, other than the recognition of an other-than-temporary impairment, that requires a financial instrument to be re-measured to its fair value at the time of the event. A new basis event does not require that instrument to be reported at fair value on a continuous basis with the change in fair value recognized in earnings.

Examples of re-measurement events are business combinations and significant modifications of debt as defined in EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments."

Classification of Securitized Interests

DIG Issue B40 provides the following guidance on how to elect classification of the securitized interest in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115) as follows:

Entities that adopted FAS 155 and identified embedded derivatives that no longer require bifurcation in accordance with the guidance in DIG Issue B40 and elected to measure the

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entire hybrid financial instrument at fair value under FAS 155 can now elect any appropriate classification in accordance with FAS 115 for the financial instrument.

SFG Observation: *There is a limited exception to reclassify securities that were previously classified as trading securities.*

In all other circumstances, the resulting financial instrument (which may no longer be a hybrid financial instrument or may be a host instrument that is different from the prior host) shall be recorded, both initially and subsequently, based on the FAS 115 classification previously elected for the prior host instrument.

Interests Acquired or Issued after June 30, 2007

All securitized interests acquired with issuance dates after June 30, 2007 must apply criterion (b) irrespective of whether the other embedded derivative(s) has an extremely remote possibility of having greater than a trivial fair value.

If a securitized interest does not meet the DIG Issue B40 exception criteria, the tests under paragraph 13(b) of FAS 133 must be performed and those tests must include consideration of the effect of the prepayment risk in the underlying financial assets.

Impact of DIG Issue B40 on DIG Issue B39

DIG Issue B40 also amends Example 6 in Statement 133 Implementation Issue No. B39, "Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor" (DIG Issue B39), to clarify that Mortgage-Backed Securities are not within the scope of DIG Issue B39.

DIG Issue B39 refers to the guidance within DIG Issue B40 for the application of paragraph 13(b) to securitized interests in pre-payable assets.

Summary

DIG Issue B40 clarifies how investors and issuers should evaluate potential derivatives in securitized financial interests. The guidance will scope out many types of securitized financial instruments. A few thoughts for investors and issuers:

1. Many securitized interests will not qualify for the FAS 155 paragraph 14 scope exception for IOs and POs due to servicing fees or guarantee fees.
2. Many securitized interests do not allow the investor to control the timing of prepayments so many interests may not require a paragraph 13b analysis.
3. All securities including IOs must still be evaluated under the 13a test, and many will be considered derivatives in their entirety.
4. The transaction structures must be carefully evaluated to identify potential interest rate derivatives that are not associated with prepayment rates. Examples include interest rate swaps, caps and floors. These types of derivatives may arise in limited circumstances, for example, an amortizing derivative contract that does not exactly mirror the collateral.

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SFG Observation: *The scope exception for evaluating derivatives that arise solely from events with extremely remote possibilities and that would not have greater than a trivial fair value at any time during the instrument's life is limited to interests issued or acquired before June 30, 2007.*

Questions

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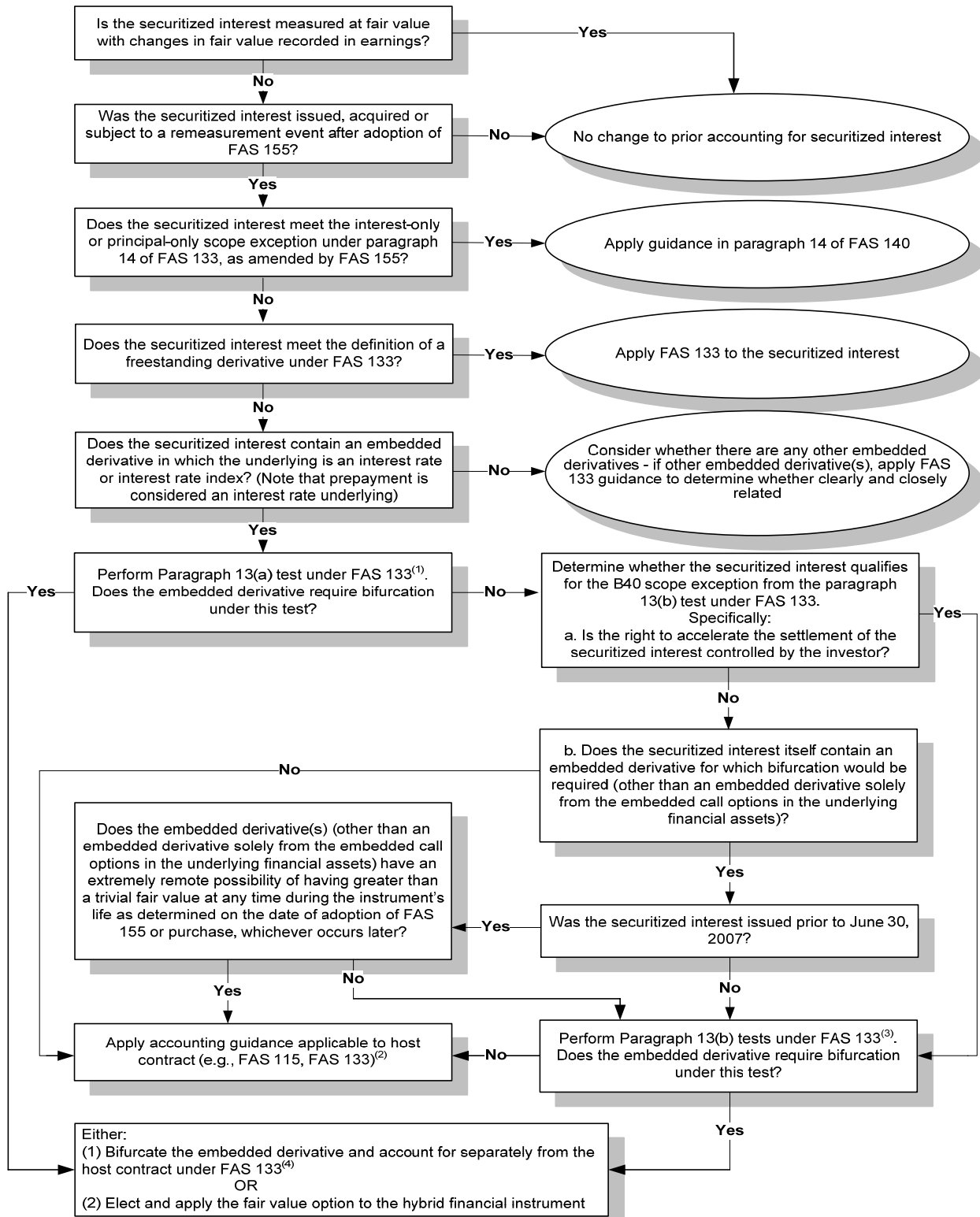
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The following decision tree provides an overview of the process to be followed in applying FAS 155 and B40 to securitized interests:

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Footnotes:

(1) The tests required under paragraph 13 of FAS 133 should be performed for each embedded derivative in which the underlying is an interest rate or interest rate index.

(2) Paragraph 14 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, requires that interest-only strips, retained interests held by transferor, loans, other receivables or other financial assets that can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of FAS 133, shall be subsequently measured like investments in debt securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115). Examples of financial assets that are subject to prepayment risk include mortgage-backed securities, collateralized mortgage obligations, real estate mortgage investment conduit interests, securitized receivables, asset-backed securities purchased at a substantial premium and held during a period of declining interest rates and high-rate debt instruments purchased at a substantial premium.

(3) The test of paragraph 13(b) of FAS 133 must include consideration of the effect of the prepayment risk in the underlying assets.

(4) The embedded prepayment call option and other embedded derivatives requiring bifurcation should be bifurcated as a compound derivative.

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Examples Excerpted from DIG Issue B40

1. Guaranteed Single-Class Mortgage Pass-Through Security	Analysis
<p>A fixed-rate guaranteed single-class mortgage pass-through security is issued, whereby the net cash flows received on the underlying fixed-rate, prepayable, single-family mortgage loans are proportionately passed through to the investors.</p> <p>Both the interest and principal payments are</p> <ul style="list-style-type: none"> • guaranteed by a third party for a fixed market-based guarantee fee, and • a servicer receives a market-based servicing fee that is expected to be more than adequate compensation. <p>Both the guarantee fee and the servicing fee have priority over the payments to the investors.</p> <p>Additionally, the investor does not have the right to accelerate the settlement of the securitized interest.</p>	<p>While the priority of the payments to the guarantor and servicer reallocates the cash flows, the example security meets the two criteria.</p> <p>SFG Observation: <i>The security does not qualify for the paragraph 14 (IO/PO) exception.</i></p> <p>Conclusion: Paragraph 13(b) is not applicable to the guaranteed single-class mortgage pass-through security.</p>

2. Securitization Trust Includes a Freestanding Derivative	Analysis
<p>Assume the same facts as presented in Example 1, except that the underlying pre-payable single-family mortgage loans have a floating interest rate.</p> <p>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 guaranteed single-class mortgage pass-through security.</p>	<p>Because the addition of the freestanding derivative (the interest rate swap) does not create an embedded derivative that requires bifurcation in the guaranteed single-class mortgage pass-through security itself, the example security meets the two criteria.</p> <p>However, if the notional amounts of the securitized loans and the interest rate swap do not match, the fixed-rate securitized interest would have to be evaluated for an embedded derivative because the financial instruments held by the entity might not provide the necessary cash flows.</p> <p>SFG Observation: <i>It generally would be difficult and/or expensive to find a swap that will perfectly match the notional amounts of the securitized loans.</i></p> <p>Conclusion: Paragraph 13(b) is not applicable to the guaranteed single-class mortgage pass-through security.</p>

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3. Sequential-Pay Collateralized Mortgage Obligation (CMO)	Analysis
<p>An entity securitizes a pool of guaranteed single-class mortgage pass-through securities (identical to those described in Example 1).</p> <p>The principal payments received, including prepayments of principal, on the underlying collateral are not allocated proportionately to all investors (bond holders).</p> <p>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.</p> <p>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.</p> <p>Additionally, the investor does not have the right to accelerate the settlement of the securitized interest.</p>	<p>The analysis of the bonds requires the holder to assess the securitized interest in accordance with criterion (b) of DIG Issue B40.</p> <p>To determine whether the individual bond classes contain an embedded derivative that requires bifurcation, the investor would have to understand the nature and amount of assets, liabilities and other financial instruments that compose the entire securitization transaction.</p> <p>The holder should obtain sufficient information about the payoff structure and the payment priority of the interest to determine whether an embedded derivative that requires bifurcation exists. Because the securitized interests (assumed to be identical to those described in Example 1) included in the re-securitization do not contain any embedded derivatives and there have been no other changes in the cash flows that create other embedded derivatives that require bifurcation, criterion (b) of DIG Issue B40 is met. 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 two criteria.</p> <p>Conclusion: Paragraph 13(b) is not applicable to any of the bond classes in the sequential-pay CMO.</p>

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4. Planned Amortization Class (PAC) and Companion CMO	Analysis
<p>An entity securitizes a pool of guaranteed single-class mortgage pass-through securities (identical to those described in Example 1).</p> <p>The principal payments received, including prepayments of principal, on the underlying collateral are not allocated proportionately to all investors (bond holders).</p> <p>Two classes of securities are issued, a PAC bond and a companion bond.</p> <p>The PAC bond is designed to reduce the prepayment risk to investors by transferring prepayment risk to the companion bond.</p> <p>The PAC bond offers a fixed principal repayment schedule that will be met if prepayment on the underlying collateral is within a specified range.</p>	<p>The analysis of the bonds requires the holder to assess the securitized interest in accordance with criterion (b) of DIG Issue B40.</p> <p>To determine whether the individual bond classes contain an embedded derivative that requires bifurcation, the investor would have to understand the nature and amount of assets, liabilities and other financial instruments that compose the entire securitization transaction.</p> <p>The holder should obtain sufficient information about the payoff structure and the payment priority of the interest to determine whether an embedded derivative that requires bifurcation exists.</p> <p>Because the securitized interests (assumed to be identical to those described in Example 1) included in the resecuritization do not contain any embedded derivatives and there have been no other changes in the cash flows that create other embedded derivatives that require bifurcation, criterion (b) of DIG Issue B40 is met.</p> <p>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 two criteria.</p>

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Additionally, the investor does not have the right to accelerate the settlement of the securitized interest.

Conclusion: Paragraph 13(b) is not applicable to either the PAC or the companion CMO.

5. Inverse Floater CMO	Analysis
<p>A CMO is issued with a coupon that fluctuates inversely with a referenced rate.</p> <p>The underlying securitized financial assets are fixed-rate, prepayable, single-family mortgage loans.</p> <p>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).</p> <p>Cash flows received on the underlying collateral are first used to pay a servicer a market-based servicing fee that is expected to be more than adequate compensation.</p> <p>Additionally, the investor does not have the right to accelerate the settlement of the securitized interest.</p>	<p>While the inverse floater CMO meets criterion (a) of DIG Issue B40, the fact that the coupon rate fluctuates inversely with the referenced rate results in the instrument failing criterion (b) of DIG Issue B40.</p> <p>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 (prepayment) options in the underlying financial assets.</p> <p>Said another way, the inverse floater meets the conditions of paragraph 13(b) without consideration of the prepayment risk in the underlying mortgage loans.</p> <p>Conclusion: Paragraph 13(b) would be applicable to the inverse floater.</p> <p>When assessing the conditions in paragraph 13(b), the holder must consider the effect of prepayment risk.</p> <p>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, which would be combined and bifurcated as one instrument.</p>

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6. Interest-Only Strip and Principal-Only Strip	Analysis
<p>An interest-only strip and principal-only strip are 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).</p> <p>The interest cash flows form one bond, which is the interest-only strip.</p> <p>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.</p>	<p>As a result of the guarantee fee and the servicing fee in excess of adequate compensation in the underlying guaranteed single-class mortgage pass-through securities, neither the interest-only strip nor the principal-only strip qualifies for the scope exception in paragraph 14 of Statement 133, as amended by FAS 155.</p> <p>The analysis of the interest-only and principal-only strip requires the holder to assess the securitized interest in accordance with criterion (b) of this DIG Issue B40.</p> <p>To determine whether the individual bond classes contain an embedded derivative that requires bifurcation, the investor would have to understand the nature and amount of assets, liabilities and other financial instruments that compose the entire securitization transaction.</p> <p>The holder should obtain sufficient information about the payoff structure and the payment priority of the interest to determine whether an embedded derivative that requires bifurcation exists.</p>

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Because the securitized interests (assumed to be identical to those described in Example 1) included in the re-securitization do not contain any embedded derivatives and there have been no other changes in the cash flows that create other embedded derivatives that require bifurcation, criterion (b) of DIG Issue B40 is met.

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 two criteria.

Conclusion: Paragraph 13(b) is not applicable to either the interest-only strip or the principal-only strip.

Excerpts from FAS 155

The Scope Exception for Interest Only and Principal Only Strips (FAS 133 as amended by FAS 155)

Paragraph 14:

However, interest-only strips and principal-only strips are not subject to the requirements of this Statement provided those strips:

- (a) represent the rights to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified proportion of the contractual principal cash flows of that debt instrument, and
- (b) do not incorporate **any terms not present** in the original debt instrument.

An allocation of a portion of the interest or principal cash flows of a specific debt instrument as reasonable compensation for:

- stripping the instrument, or
- to provide adequate compensation to a servicer (as defined in Statement 140) would meet the intended narrow scope of the exception provided in this paragraph.

However, an allocation of a portion of the interest or principal cash flows of a specific debt instrument to provide for

- a guarantee of payments,
- servicing in excess of adequate compensation, or
- any other purpose would not meet the intended narrow scope of the exception.

Paragraphs 14A and 14B are added as follows:

14A. 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.

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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.

14B. Changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative contracts) that represent the assets or liabilities that are held by the issuing entity shall not be considered an embedded derivative under this Statement.

The concentration of credit risk in the form of subordination of one financial instrument to another **shall not** be considered an embedded derivative under this Statement.

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Excerpts from DIG Issue B40

Statement 133 Implementation Issue No. B40 -- Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Pre-payable Financial Assets

Paragraph references: -- 13(b), 14A, 61(a), 61(d)

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QUESTION

Are there circumstances in which a securitized interest in pre-payable 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.

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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.^{6a}
- 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.]

^{6a} 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 both of the following criteria:

a. The right to accelerate the settlement of the securitized interest cannot be controlled by the investor.

b. 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.¹

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

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tioned to the prepayment risk of the underlying prepayable financial assets and that meet 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), that securitized interest would be subject to the requirements of paragraph 13(b) of Statement 133 (for example, an inverse floater).

As discussed in Statement 133 Implementation Issue No. B39, "Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor," the conditions in paragraph 13(b) were intended to apply only to situations that meet the two conditions specified in paragraphs 13(b)(1) and 13(b)(2) and for which the investor has the unilateral ability to obtain the right to receive the high rate of return specified in those paragraphs.

Questions later arose about whether that guidance was intended to apply to securitized interests when the underlying assets are pre-payable. Because the securitization process allows for the reallocation of risk, the Board decided that the investor's ability to obtain the right to receive the high rate of return specified in those paragraphs should not be the only condition considered when applying paragraph 13(b) to securitized interests.

The Board decided to add another criterion to ensure that securitized interests are evaluated for embedded derivatives that are not related to the embedded call options in the underlying assets.

Whether the securitized interest itself contains 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, should be determined in accordance with paragraph 14A of Statement 133.

This assessment is expected to be simple for basic securitized interests but could be more difficult for complex securitized interests (for example, in securitizations involving the resecuritization of tranches from previous transactions, the analysis might require an understanding of each securitization making up the resecuritization transaction).

A securitized interest in prepayable financial assets that does not meet both of the above criteria 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.

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The table below illustrates the application of this guidance to specific securitized interests in prepayable financial assets. The analysis of the examples considers only paragraph 13(b) of Statement 133, which is the subject of this Issue. The examples provide no discussion of the requirements of paragraphs 12 and 13(a) of Statement 133; however, an analysis of those paragraphs would be required to determine whether the instruments meet criterion (b) of this Issue.

EFFECTIVE DATE AND TRANSITION

The guidance in this Issue shall be applied upon adoption of Statement 155 (except, in certain circumstances, for criterion (b)).

Criterion (b) of this Issue is not applicable to securitized interests

(a) that were issued before June 30, 2007, and

(b) that only include embedded derivatives, other than an embedded derivative that results solely from the embedded call options in the underlying financial assets, that have an extremely remote possibility of having greater than a trivial fair value at any time during the instrument's life (for example, an embedded derivative that only has value when an interest rate index reaches an extremely remote level) as determined on the adoption of Statement 155 or the purchase of the instrument, whichever occurs later.

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. An entity is not permitted to change the FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, classification of the instrument on the application of this guidance.

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 in this Issue retrospectively to the date of adoption of Statement 155.

If in applying this guidance retrospectively the entity must recombine a host instrument with a previously bifurcated embedded derivative, that entity shall reverse any changes in the fair value of the embedded derivative that were previously recognized in income.

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Additionally, entities required to retrospectively apply the guidance in this Issue shall classify the instrument as follows:

a. Entities that upon applying Statement 155

(1) previously identified embedded derivatives that no longer require bifurcation in accordance with the guidance in this Issue and

(2) elected to measure the entire hybrid financial instrument at fair value under that Statement, may elect any appropriate classification in accordance with Statement 115 for the financial instrument.

b. In all other circumstances, the resulting financial instrument (which may no longer be a hybrid financial instrument or may be a host instrument that is different from the prior host) shall be classified in the Statement 115 category previously elected for the prior host instrument.

DISSENT

One Board member dissents from the issuance of this Implementation Issue. That 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 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.

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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 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 has been approved by the Board by written ballot.

¹ See Effective Date and Transition for the delayed effective date for this criterion.

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Appendix -- 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 December 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 [added text is underlined and deleted text is ~~struck out~~]:

- 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 pre-payable, 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.

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