

*Capital Markets
Accounting Developments
Advisory 2004-01*

January 23, 2004

Overview

Statement of Financial Accounting Standards No. 149 ("FAS 149" or the "Statement"), *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Was issued in order to:

- Address some of the implementation issues involving the interpretation and application of the definition of a derivative -- in particular, interpreting the meaning of:
 - (1) the phrase *an initial net investment that is small than would be required for other types of contracts that would be expected to have a similar response to changes in market factors*,
 - (2) the use of the term *underlying*, and
 - (3) issues about how to discern the characteristics of a derivative that contains a financing component,
- Incorporate some of the conclusions reached as part of the Derivatives Implementation Group (DIG) process that ultimately made it necessary to amend FAS 133, and
- Align FAS 133 with the decisions that the Board has reached in other FASB projects dealing with financial instruments

SFG Observation: *The exposure draft that led to FAS 149 included implementation issues related to DIG Issue D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets.*

During the deliberation process, however, the Board decided to address those issues in a separate project. The issues are not part of an active FASB project.

Definition of a Derivative Initial Net Investment (Amended Paragraph 8)

The Statement clarifies that a contract satisfies the “initial net investment” criterion in paragraph 6(b) of FAS 133 if it results in an initial net investment (after it is adjusted for the time value of money) that is **less by more than a nominal amount than** the initial net investment that would be commensurate with the amount necessary to acquire the asset related to the underlying or to incur an obligation related to the underlying.

SFG Observation: *During the deliberation process, the Board discussed whether it would be appropriate to establish a quantitative threshold for the initial net investment criterion. The Board ultimately decided that a bright line should not be incorporated into the guidance.*

The guidelines in the following table can be used, as a starting point, in applying the concept of “less by more than a nominal amount” to a prepaid interest rate swap. The guidance is based, in part, on DIG Issue A23.

| Initial Net Investment | | | |
|---|--|--|--|
| Initial net investment relative to notional or amount derived by applying the notional to the underlying | Initial net investment as a percentage of notional or amount derived by applying the notional to the underlying | Satisfies “initial net investment” criterion in par. 6(b) | Derivative in its entirety or a hybrid contract |
| <i>Less by more than nominal amount</i> | <i>85% or less</i> | <i>Yes</i> | <i>Derivative</i> |
| <i>Less by only a nominal amount</i> | <i>86% - 99%</i> | <i>No</i> | <i>Hybrid</i> |
| <i>Equal</i> | <i>100%</i> | <i>No</i> | <i>Hybrid</i> |
| <i>Greater than</i> | <i>100+%</i> | <i>No</i> | <i>Hybrid</i> |

Definition of a Derivative - Underlying (Amended Paragraph 7)

The definition of an underlying was expanded to cover the occurrence or non-occurrence of a specified event.

The Board modified the definition so that it would be consistent with how the term is defined in FASB Interpretation No. 45, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*.

Existing Securities (Amended paragraphs 10(a) and 58(a))

For entities that are “**required**” to account for security transactions on a trade-date basis (rather than a settlement-date basis), the regular-way scope exception for existing securities was **extended** to contracts that:

- require or permit net settlement, or
- for which there is a market mechanism that will facilitate net settlement.

When-Issued Securities or other securities that do not yet exist (Amended Paragraph 59(a))

FAS 149 clarifies the applicability of “regular way” security trade scope exception to contracts for forward purchases or sales of when-issued or other securities that do not yet exist (e.g., **TBA securities**).

If an entity is “**required**” to account for a contract for the purchase or sale of when-issued or other securities that do not yet exist on a trade-date basis, rather than a settlement date basis that entity shall apply the regular-way security trades exception to those contracts. This is an automatic exception **without** the need to satisfy any additional criteria.

Even though an automatic exception may not be available to an entity because it is **not** “required to account for the contract on a trade-date basis”, the contract may still be eligible for the “regular way security trade” scope exception if it meets **all** of the following conditions:

1. There is no other way to purchase or sell the security,
2. Delivery and settlement will occur within the shortest period possible for that type of security, and
3. It is probable at inception, and throughout the term, that the contract will **not** be net settled and will result in physical delivery of a security when it is issued (documentation of the entity’s basis for concluding that it is probable that the contract will result in physical settlement is required)

Net settling contracts that were previously considered eligible for this scope exception would call into question the continued exemption of other similar contracts.

SFG Observation: *A number of implementation questions have impacted the application of the language in FAS 149. The implementation Issues involve existing securities as well as to securities that do not yet exist.*

Financial Guarantee Contracts Scope Exception (Amended Paragraph 10(d) and superseded DIG Issue C7)

Financial guarantee contracts are not subject to FAS 133 only if they meet all of the criteria described below:

1. The contract provides for payment solely to reimburse the guaranteed party for the debtor’s failure to satisfy its required payment obligations under a non-derivative contract, either
 - at pre-specified payment dates, or

- accelerated payment dates as a result of the occurrence of an event of default (as defined in the financial obligation covered by the guarantee contract), or
 - a notice of acceleration being made to the debtor by the creditor,
2. Payment under the contract is made only if the debtor's obligation to make payments as a result of conditions as described above is past due, and
 3. The guaranteed party is, as a precondition in the contract (or in the back-to-back arrangement, if applicable) for receiving payment of any claim under the guarantee, exposed to the risk of non-payment both:
 - at inception of the financial guarantee contract and throughout its term either through direct legal ownership of the guaranteed obligation, or
 - through a back-to-back arrangement with another party that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.

SFG Observation: *The revised language in paragraph 10(d) as well as the additional discussion in paragraphs A20-A23 in the "Background and Basis for Conclusions" section of FAS 149 have reaffirmed the pre-FAS 149 requirements for the financial guarantee exception and made the exception more restrictive. The revised guidance:*

1. *Reaffirms that the financial guarantee exception is only applicable to contracts that provide for payment to the guaranteed party **solely** to reimburse the party for the debtor's failure to satisfy its required payment obligations, rather than for any event of default.*
2. *Emphasizes that the guaranteed party **must demand** payment from the debtor prior to collecting any payment from the guarantor in order for a guarantee contract to be eligible for the scope exception.*
3. *Incorporates the concepts in the superseded DIG Issue C7, Scope Exceptions: Certain Financial Guarantee Contracts, with additional restrictions.*

*For example, the revised guidance more clearly indicates that the guaranteed party must be exposed to **risk of nonpayment** (not just "risk of loss").*

The revisions also indicate that the risk of nonpayment must be through direct legal ownership of the guaranteed obligation (or through a "back-to-back" arrangement).

4. *Adds an additional criterion (through the Basis For Conclusions section of FAS 149) for a contract to qualify for the paragraph 10 (d) exception.*

The guarantor must receive the rights to any payments on the defaulted receivable paid to the guaranteed party on the defaulted receivable.

Based on these revisions, a contract that promises to pay the guaranteed party the difference between the post-credit-event FV and the book value would not qualify for the scope exception. A contract with a net payment provision would be considered net settled.

These revisions are consistent with the Board's intent that guarantees eligible for the scope exception must entitle the holder to compensation as a result of an identifiable insurable

event (failure to pay on a specific asset for which the holder is at risk) rather than merely a credit event.

Certain Investment Contracts Scope Exception (Added Paragraph 10(h))

The Board added a new scope exception for contracts that are accounted for under:

- Statement of Financial Accounting Standards No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*,
- Statement of Financial Accounting Standards No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, or
- Statement of Position No. 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*.

The exception applies only to the party that accounts for the contract under the above-mentioned literature.

Derivatives That Contain Financing Elements (Added Paragraph 45A)

Two characteristics are associated with a derivative that contains a financing element:

- an up-front cash payment, and
- off-market terms.

FAS 149, however, acknowledges that identifying a financing element within a derivative is a matter of judgment that depends on the facts and circumstances specific to that derivative.

FAS 141 requires that if an “other-than-insignificant” financing element is present at inception, the borrower should report all cash inflows and outflows associated with that derivative as a financing activity in the statement of cash flows.

SFG Observation: *FAS 149 does not establish any bright lines for determining what is “other-than-insignificant.” We understand that the term “insignificant” denotes an amount that is less than 10 percent of the present value of an at-the-market derivative’s fully prepaid amount.*

For example, assume the following:

- *Company A enters into a two-year \$100 million notional interest rate swap that has a pay receive fixed rate of 5 percent and a pay floating rate that is set at LIBOR.*
- *Company A receives an upfront payment from the counterparty in the amount of \$1,920,000.*
- *An at-the-market swap would contain a receive fixed leg of 4 percent and a pay leg that is set at LIBOR; the present value of prepaying the fixed leg would be \$7,680,000.*

In this example, the embedded financing element represents 25 percent of the PV of the fully prepaid at-the-market swap. The prepayment would be considered significant.

As a result, the swap will be subject to the statement of cash flows reporting requirements described in paragraph 45A of FAS 133.

Short-cut Method (Amended Paragraph 68(b))

Paragraph 68(b) relating to the short-cut method was modified to require that the premium for a mirror-image call or put option contained in an interest rate swap be paid or received in the same manner as the premium on the call or the put embedded in the hedged item.

If the implicit premium for the call or put option that is embedded in the hedged item was principally paid at the time of inception or acquisition, the fair value of the hedging instrument at the inception of the hedging relationship must equal the fair value of the mirror-image call or put option.

In contrast, if the implicit premium for the call or put option that is embedded in the hedged item is principally being paid over the life of the hedged item through an adjustment of the interest rate, the fair value of the hedging instrument at the inception of the hedging relationship must be zero.

SFG Observation: *When evaluating hedges of “prepayable” debt under the short-cut method, companies should carefully evaluate the economics of the prepayment feature (i.e., the embedded call or put option).*

The analysis should compare:

- *the method by which the premium is paid (e.g. up-front through an original issue discount or premium, over the term of the debt as a yield adjustment, or a combination thereof), and*
- *the strike prices of the “mirror-image” options in the debt and interest rate swap.*

The timing of payment and the strike prices should match.

DIG Issue E20: The Strike Price for Determining When a Swap Contains Mirror-Image Call Provision, should be followed when the strike prices are being evaluated.

Embedded Foreign Currency Derivatives (Amended Paragraph 15)

FAS 149 expands upon the conditions under which embedded foreign currency derivatives should not be bifurcated from the host contracts that are not financial instruments.

The Statement clarifies that the evaluation of whether a contract qualifies for this exception should be performed only at the inception of the contract.

Amendments to Incorporate Conclusions in Cleared DIG Issues

The following is a summary of the more significant amendments to FAS 133 related to conclusions reached in cleared DIG Issues:

Transition and Effective Date

Amendments related to previously cleared DIG Issues that have not been modified as a result of the amendment should continue to be applied in accordance with the respective effective dates of the original DIG Issues.

The amendment of DIG Issue C13 with respect to loan commitments to “acquire” mortgage loans must be applied prospectively to all contracts that are entered into after June 30, 2003.

The transition related to forward purchases or sales of when-issued or other securities that do not yet exist is applicable to both existing contracts and new contracts entered into after June 30, 2003.

All other provisions of the Statement apply prospectively to contracts entered into or modified after June 30, 2003.

Questions

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Attachments

| Amendments to Incorporate DIG Guidance | | |
|--|---------------------------|-------------------|
| Summary of Amendment | FAS 133 Paragraph Amended | Related DIG Issue |
| <p><u>Loan Commitments Scope Exception</u></p> <p>Loan commitments relating to the origination of mortgage loans that will be held for sale (as discussed in paragraph 21 of Statement of Financial Accounting Standards No. 65, <i>Accounting for Mortgage Banking Activities</i>) are within the scope of FAS 133 for the issuer of the loan commitment (that is, <i>the potential lender</i>).</p> <p>The issuer of commitments to originate mortgage loans that will be held for investment purposes (as discussed in paragraphs 21 and 25 of FAS 65), as well as the issuer of commitments to originate other types of loans (that is, loans other than mortgage loans) are not subject to FAS 133.</p> <p>The holder of any commitment to originate a loan (that is, <i>the potential borrower</i>) is not subject to FAS 133.</p> <p>SFG Observation: <i>The guidance in DIG Issue C13 (which was cleared on March 13, 2002) provided a scope exception for commitments to “originate or acquire” mortgage loans that will be held for investment purposes.</i></p> <p><i>The Board had received questions from constituents relating to commitments to acquire a mortgage loan, e.g., whether forward purchases and sales of mortgage loans were exempt from FAS 133.</i></p> <p><i>FAS 149 clarifies that forward commitments to purchase or sell existing loans are not eligible for the scope exception in paragraph 10(i) of FAS 133, and that the definition of a derivative should be applied to forward commitments to determine if they are subject to FAS 133.</i></p> | 6, 10(i) | C13 |

| Summary of Amendment | FAS 133 Paragraph Amended | Related DIG Issue |
|--|----------------------------------|--------------------------|
| <p><u>Normal Purchases and Normal Sales (NPNS)</u></p> <p>The applicability of the NPNS scope exception to forward contracts, freestanding option contracts, forward contracts with optionality and power purchase/sales agreements is addressed in FAS 149 as follows:</p> <p>The scope exception is not available if the price is based on an underlying that is not clearly and closely related to the asset that is being sold or purchased.</p> <p>The scope exception is not available for forward contracts that meet paragraph 9(a) or 9(b) of FAS 133 unless it is probable that the contracts <u>will not net settle</u> and will result in a physical delivery.</p> <p>Forward contracts with optionality are eligible for the scope exception only if the quantity <u>cannot be modified</u> (except for the purpose of permitting the holder to purchase or sell additional quantities at the market price on the date of delivery).</p> <p>Power purchase or sales agreements are eligible only if they meet the criteria in paragraph 58(b) of FAS 133; specifically, optionality of quantity is permitted if certain conditions are satisfied.</p> <p>For power purchase or sales agreements to qualify for the scope exception additional documentation is required.</p> <p>SFG Observation: <i>The Board recognized certain unique characteristics of the electric industry and decided that the scope exception in paragraph 10(b) should be extended to power purchase and sales agreements when they meet certain criteria, even if the agreements include optionality features that can modify the quantity of the asset that is to be delivered.</i></p> <p><i>If specified criteria are met, paragraph 58(b) clarifies that the power purchase or sales agreements qualify for a scope exception even if they are subject to being booked out or are scheduled to be booked out.</i></p> | <p>10(b), 58(b)</p> | <p>C10, C15, C16</p> |

| Summary of Amendment | FAS 133 Paragraph Amended | Related DIG Issue |
|--|----------------------------------|--------------------------|
| <p><u>Investments in life insurance</u></p> <p>A policyholder's investment in a life insurance contract that is accounted for under FASB Technical Bulletin No. 85-4, <i>Accounting for Purchases of Life Insurance</i>, is <u>exempt</u> from FAS 133.</p> <p>This scope exception affects only the accounting by the policyholder and does not affect the accounting by the issuer of the contract.</p> | 10(g) | B31 |
| <p><u>Embedded Interest Rate Derivatives</u></p> <p>Embedded derivatives in which the underlying is an interest rate or interest rate index (e.g., caps and floors) are not considered clearly and closely related if</p> <p>(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 investors initial rate of return on the host contract, and</p> <p>(2) under each of these possible scenarios, the embedded derivative would at the same time result in at least twice the then-current market return for a contract that has the same terms as those of the host contract and that involves a debtor that has a credit quality similar to the credit quality that the issuer had at the contract's inception.</p> <p>SFG Observation: <i>The amendments to paragraph 13(b) convey the Board's intent that when evaluating an embedded interest rate cap or floor. The borrower's credit quality should be assumed to be unchanged since the contract's inception.</i></p> | 13(b), 61(f) | |
| <p><u>Foreign Exchange Risk</u></p> <p>FAS 149 addresses foreign currency cash flow hedges of recognized assets and liabilities that use an option contract.</p> <p>FAS 149 specifies that if the assessment of effectiveness and the measurement of ineffectiveness are based on total changes in the option's cash flow, the cost of the option (i.e., the time value) must be reclassified from other comprehensive income (OCI) to earnings on a rational amortization basis.</p> | 30(d) | G20, H15 |

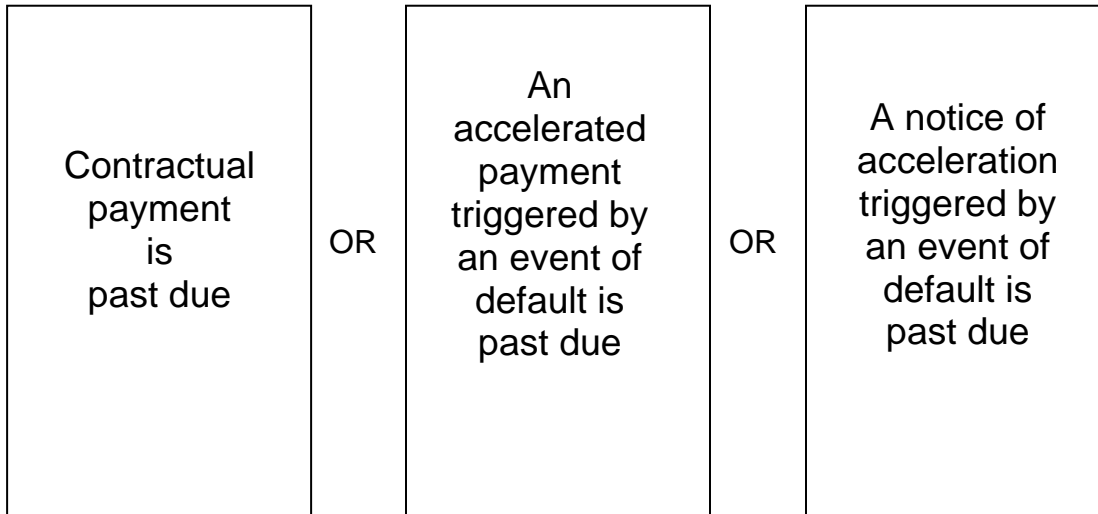
| Summary of Amendment | FAS 133 Paragraph Amended | Related DIG Issue |
|--|----------------------------------|--------------------------|
| <p><u>Restricted Stock</u></p> <p>The Statement permits shares to be delivered under warrants to be considered restricted and not readily convertible to cash under paragraph 9(c) only when:</p> <ol style="list-style-type: none">1. The stock purchase warrant is issued <u>by an entity</u> for only its own stock, and2. The sale or transfer of the underlying shares is restricted (by the issuer) for a period of 32 days or more, starting from the date that the warrant is exercised <p>This guidance should not be applied by way of analogy to any contract other than a stock purchase warrant.</p> | 57(c)(3) | A14 |

Eligible Payment Exposures

| | |
|---|--|
| Risk of non-payment throughout the contract term: | |
| Direct legal ownership | Back-to-back arrangements that requires direct legal ownership |

Qualifying Reimbursable Exposures

An obligation that is past due



Loan Commitments by the lender

