



# FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments

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# Hybrid Financial Instruments

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- FASB Statement 155 issued in February 2006
  - Amends FASB 133 and 140
- Why this project?
  - Eliminate temporary exemption for beneficial interests in securitized financial assets from the bifurcation requirements of FASB 133 (prospectively)
  - Simplify accounting for hybrids by allowing fair value election for the entire instrument

# Hybrid Financial Instruments


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- Elimination of temporary exemption in DIG Issue D1
  - Interests in securitized financial assets must now be evaluated for derivatives
  - IO and PO strip exemption refined
    - No modifications to the strips can be made.
    - Excepts only those strips that represents rights to receive contractual principal and/or interests cash flows.
    - Incremental servicing fees, guarantee fees, other changes in terms would not qualify for the exception

# Hybrid Financial Instruments

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- Credit risk and concentration of credit risk in securitized financial assets are not considered embedded derivatives under FASB 155



**Many, many  
securitizations  
have  
redistributed  
credit risk**

# Paragraph 14 of Statement 133

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- Factors that may affect eligibility to use IO/PO exemption
  - Servicing fees in excess of adequate compensation
  - Guarantee fees
  - Pools of debt securities

# Paragraph 14 of Statement 133 (cont'd)

- Example 1
  - Government sponsored agency issues IO and PO strips backed by fixed rate MBS it has guaranteed
  - Investor in IO strip is entitled to 100% interest, no principal
  - Investor in PO strip is entitled to 100% principal, no interest
  - Is paragraph 14 exemption met?
- Answer:
  - No. Because of the guarantee and related fees, the IO and PO strip would not meet the intended narrow scope of the exception. Ineligibility to use the exemption cannot be cured through a resecuritization.

# DIG Issue B39

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## Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor

- Paragraph 13(b): embedded derivative with interest underlying would **not** be clearly and closely related to an interest-bearing host if:
  - Investor can at least double return; and
  - Would result in a rate of return at least twice what otherwise would be the then-current return for a contract with same terms and credit quality of the host contract.
- DIG Issue B39: if embedded is an option (not forward), in addition to 13(b)(1) and 13(b)(2), investor must have the unilateral ability to obtain the right to receive the high rate of return.

# DIG Issue B39, (cont'd)

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- Example 6 in DIG Issue B39, as amended:
  - If underlying assets of MBS incorporate an embedded call feature, are all associated cash flows proportionately passed through to all the interest holders?
    - Yes – 13(b) does not apply
    - No – Apply paragraph 13(b)
- Example 6 doesn't consider that investor doesn't have unilateral ability to obtain "more than double" yield.

# DIG Issue B39, (cont'd)

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## Example 1

- A CMO structure backed by prepayable single-family mortgage loans with a weighted average coupon of 6.5 percent issues three classes of certificates in the following order of seniority:
  - Class A certificates
  - Class B certificates
  - Class C certificates
- Principal payments received (both scheduled and prepayments) are first allocated entirely to Class A
- After Class A are retired, all principal payments are then allocated entirely to Class B.
- After both Class A and Class B are retired, all principal payments are allocated to Class C.

NOTE: CMO structure does not modify the prepayment option of the underlying mortgage loans.

# DIG Issue B39, (cont'd)

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- What is your view?
- Must the provisions of paragraph 13(b) be applied?
  - View A – No, the investor does not have unilateral ability to double the rate of return.
  - View B – Yes. Example 6 is clear. Cash flows are being disproportionately allocated.
  - View C – Help!

# DIG Issue B39, (cont'd)

- Impact of view B if applied:
  - Assume the same facts as the previous example – In addition, assume the Class A security was subsequently sold at a slight discount (e.g. 99) as a result of a change in interest rates and all of the underlying mortgages prepaid the next day.
  - The interest would fail paragraph 13(b) because the holder would immediately collect 100 (the amount of the discount), which results in an annualized return that would fail the paragraph 13(b) tests.

# DIG Issue B39, (cont'd)

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- Example 2

- Trust issues one series of MBS backed by fixed-rate mortgages:
  - MBS guaranteed by GSE (e.g., Fannie Mae)
  - Servicer records a servicing asset (servicing fee is more than adequate compensation)
- If MBS are acquired in secondary market, they may be acquired at a discount.
- If all mortgages prepay the next day, MBS purchased at discount would fail paragraph 13(b).
- Must evaluate paragraph 13(b) if you consider guarantee fee or servicing asset “interests” because they do not receive proportional allocation of prepayment cash flows.

# DIG Issue B40

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- October 25<sup>th</sup> FASB Meeting
  - Exception to paragraph 13(b)
    - The right to accelerate the settlement of the securitized interest can not be exercised by the investor,
    - The underlying financial assets do not contain an embedded derivative that requires bifurcation, and
    - 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.

# Paragraph 13(a) of Statement 133

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Paragraph 13(a): an embedded derivative with interest rate underlying is NOT clearly and closely related to a debt host if the hybrid instrument can contractually be settled so that the investor (holder) will not recover substantially all of its initial recorded investment.

# Paragraph 13(a) of Statement 133 (cont'd)

## Example

- SPE holds fixed rate loans with a principal amount of \$100,000.
- SPE issues variable rate notes with a principal amount of \$100,000.
- SPE enters into a pay-fixed, receive variable interest rate swap with a notional amount of \$100,000.
- The loans are subject to prepayment and the notional amount of the swap is amortized based on the prepayment expectations as of the securitization date.

Does the interest rate swap embedded in the variable rate notes need to be bifurcated?

# Paragraph 13(a) of Statement 133 (cont'd)

## View A –

Yes. If the fixed rate loans prepay at a faster rate than the notional amortization of the interest rate swap such that the notional of the swap exceeds the principal of the underlying loans, it is possible that the investor may not recover substantially all of its recorded investment in the notes, as the fixed rate loans will have insufficient cash flows to provide the investor its expected return if the swap is in a pay position (i.e. if rates drop).

## View B –

No. By analogy to FASB Staff Position 140-2 "Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement 140", if, when the investor acquires the beneficial interest, it expects the fixed rate loans will provide the necessary cash flows to the investor, then the investor passes the paragraph 13(a) test and does not have to bifurcate the embedded derivative. Unexpected prepayments beyond the investor's control that occur subsequent to the investor's initial analysis will not change this conclusion.

## View C –

Help!

# Hybrid Financial Instruments

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- Fair value measurement election
  - Scope
    - Recognized hybrid financial instruments with embedded derivatives that would otherwise require bifurcation
    - Must fully evaluate to determine whether an embedded exists

# Hybrid Financial Instruments

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- When can the election be made?
  - On adoption of FASB 155 for existing hybrids
  - Initial recognition of a hybrid financial instrument
  - Remeasurement (new basis) event
    - Examples include a business combination, significant modification of debt



**Not other-than-temporary impairments!**

# Hybrid Financial Instruments

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- Fair value measurement election (cont'd.)
  - Documentation
    - Concurrent or preexisting policy for automatic election
  - Instrument-by-instrument
  - Hybrids measured at fair value may not be designated as a hedging instrument
  - Disclosure requirements
    - Balance sheet presentation
    - Income statement disclosures



# Hybrid Financial Instruments

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- Other highlights of FASB 155
  - Amendment to FASB 140
    - Changes the restriction on passive derivative instruments that may be held by a QSPE
      - Eliminates the requirement that derivatives in QSPEs must pertain to beneficial interests other than other derivatives.
  - How does this affect QSPE status?

# Hybrid Financial Instruments

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## – Effective date

- Beginning as of the first fiscal year after September 15, 2006
- Early adoption permitted as of beginning of fiscal year (e.g., January 1, 2006 for calendar year-end entities)



**Provided no interim  
financial statements  
have been issued**

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