Note: The answers to the following questions represent tentative conclusions. The status of the guidance will remain tentative until it is formally cleared by the FASB Board and incorporated in an FASB staff implementation guide. Constituents should send their comments, if any, to Suzanne Bielstein, Director of Major Projects and Technical Activities, FASB 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116 (or by email to director@fasb.org) by July 1, 2002.

**Topic:** Questions and Answers Related to Derivative Financial Instruments Held or Entered into by a Qualifying Special-Purpose Entity (SPE)

In September 2000, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The FASB staff determined that the following questions and answers should be issued as an aid to understanding and implementing Statement 140 because of certain inquiries received on specific aspects of that Statement.

The Board reviewed the following questions and answers in a public meeting and did not object to their issuance. The questions and answers will be included in a future edition of the *FASB Staff Implementation Guides*.

**Questions and Answers on Statement 140**

**General**

1. **Q**—Do the disclosure requirements of paragraphs 17(f)(3) and 17(g) of Statement 140 apply to hybrid instruments, containing derivatives, that are retained in a securitization?

   **A**—Yes. The disclosure requirements in paragraphs 17(f)(3) and 17(g) apply to retained interests. Under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, hybrid instruments that must be bifurcated contain two components for accounting purposes—a derivative financial instrument and a nonderivative host contract. The derivative financial instrument component is not a retained interest as defined in Statement 140, so the disclosures that pertain to retained interests, although permitted, are not required for that portion of a bifurcated hybrid instrument; however, the disclosures required by Statement 133 (paragraphs 44 and 45) do apply to the derivative financial
instrument component. The host contract is a retained interest so the disclosure requirements in paragraphs 17(f)(3) and 17(g) apply to the host contract. Hybrid instruments that are not bifurcated, because they will be subsequently accounted for in their entirety at fair value with changes in fair value reported in earnings as they occur, are not considered to be derivative financial instruments. Therefore, the disclosure requirements in paragraphs 17(f)(3) and 17(g) apply to those interests in their entirety.

**Derivative Financial Instruments Entered into by Qualifying SPEs**

2. *Q—Which types of derivative financial instruments are subject to the limits on what a qualifying SPE may hold in paragraphs 39 and 40 of Statement 140?*

   *A—Those limits apply to any financial instrument that (1) either meets the definition of a derivative instrument in paragraphs 6–9 of Statement 133 or contains an embedded derivative financial instrument that meets the criteria in paragraphs 12(a) and 12(c) of Statement 133 and (2) is, or could become, an asset. Thus, an entity can be a qualifying SPE only if, for example, any purchased options, caps, forward contracts, swaps, and most other derivative financial instruments transferred to it or entered into by it conform to the provisions of paragraph 35(c)(2), which require that a derivative financial instrument held by a qualifying SPE be passive (as further described in paragraph 39) and not pertain to another derivative financial instrument (as further described in paragraph 40).

Paragraph 39 explains that “derivative financial instruments that result in liabilities . . . are a kind of beneficial interest in the qualifying SPE’s assets.” Therefore, a qualifying SPE can enter into derivative financial instruments that are liabilities (for example, written options) but only if they conform to the applicable provisions of paragraph 35(d)(3) if held by the transferor, its affiliates, or its agents or paragraphs 35(d)(2) and 44 if held by another party.

Derivative financial instruments that result in assets or liabilities (for example, swaps and forward contracts) are subject to the limits of paragraphs 35(d), 39, 40, and 44.
3. **Q**—What is the effect of the language in paragraph 40 that requires that a derivative financial instrument “pertain to beneficial interests (other than another derivative financial instrument) . . .”?

**A**—A derivative financial instrument that pertains to a beneficial interest that is also a derivative financial instrument does not meet the limits of paragraph 40 of Statement 140. For example:

**Example 1**

An entity transfers Treasury bonds and a long forward contract indexed to the S&P 500 to an SPE. That SPE issues bonds (paying the same rate as the Treasury bonds) and a short forward contract indexed to the S&P 500 to a third party. The SPE is not a qualifying SPE because the derivative financial instrument (the long forward contract) pertains in whole or in part to another derivative financial instrument (the short forward contract).

**Example 2**

A transferor transfers fixed-rate loans with a fair value of $100 to an SPE. The SPE enters into a fixed-to-floating interest rate swap with a notional amount of $80 and issues a floating rate beneficial interest to a third party for $80. The transferor retains a $20 interest in the SPE. The SPE can be a qualifying SPE (if all other relevant provisions of Statement 140 have been met) because the interest rate swap pertains to the floating rate beneficial interest, which is not a derivative financial instrument, and the notional amount of that swap does not exceed the amount of beneficial interests held by parties other than the transferor, its affiliates, or its agents.
4. *Q—* What procedure is needed to determine whether a financial instrument containing embedded derivatives can be transferred to, entered into, or issued by a qualifying SPE?

*A—* To apply Statement 140, any embedded derivative financial instruments held, entered into, or issued by the SPE should first be bifurcated using the guidance in Statement 133.¹

The next step is to assess what that separately accounted for derivative financial instrument pertains to. For example:

**Example 1**

An entity transfers Treasury bonds and a long forward contract indexed to the S&P 500 to an SPE. The SPE issues equity-linked bonds that pay a periodic fixed coupon but have principal that is indexed to the S&P 500. The SPE would have to bifurcate the beneficial interest (the equity-linked bonds) into a debt host and a forward contract indexed to the S&P 500, because equity-linked returns are not clearly and closely related to a debt host contract. The SPE is not a qualifying SPE because it holds a derivative financial instrument (the long forward contract) that pertains in whole or in part to another derivative financial instrument (the short forward contract embedded in the equity-linked bonds).

**Example 2**

An entity transfers Treasury bonds to an SPE, which also enters into a fixed-to-floating interest rate swap with a notional amount equal to the par amount of the Treasury bonds. The SPE issues floating rate bonds to third parties. The beneficial interests (the floating rate bonds) do not contain an embedded derivative financial instrument that must be bifurcated under the provisions of Statement 133 because interest rates are clearly and closely related to a debt host and the provisions of paragraph 13 have been met. The transferor then determines that the fixed-to-floating interest rate swap pertains to the (nonderivative) beneficial interest. The SPE can be a qualifying SPE if all other relevant provisions of Statement 140 are met.

¹ For purposes of applying this procedure, the bifurcation exceptions in paragraph 12(b) and 16 of Statement 133 do not apply because measurement of the embedded derivative financial instrument is not relevant to this determination.
5. Q—Paragraph 40(b) requires that a derivative financial instrument held by a qualifying SPE have a notional amount that does not initially exceed the amount of (nonderivative) beneficial interests held by parties other than the transferor, its affiliates, or its agents. How is the appropriate notional amount determined?

A—Paragraph 540 of Statement 133 defines a notional amount as “a number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument.” That definition (and the related guidance in Statement 133) should also be used to determine a derivative financial instrument’s notional amount for the purposes of applying Statement 140.

In some cases, the notional amount of a derivative instrument will be readily determinable from the terms of the instrument. In other cases, the notional amount of a derivative financial instrument may be inferred from the terms of the derivative financial instrument that is (or would be) bifurcated from its (non derivative) host contract. The notional amount of an instrument can change over time as, for example, in certain amortizing swaps.

The “amount” of the (nonderivative) beneficial interests can be determined using similar reasoning. Typically, the amount in question is the amount based on which periodic interest payments are determined. It is often (but not always) the instrument’s par or redemption amount.

The notional amounts of the derivative instrument and the nonderivative beneficial interest should be compared at the time the cash payments/receipts on the derivative financial instrument are to take place. For example:

A floor purchased by a qualifying SPE will require a single payment, based on a notional amount of $100, in 3 years if interest rates drop sufficiently so that it is in the money. The beneficial interest to which the floor pertains is a $100 zero-coupon note (priced to yield 10 percent, compounded annually). The initial “amount” of beneficial interest is $75.13, and it changes as interest accrues. Therefore, the beneficial interest amount is $75.13 at inception, $82.64 at the end of Year 1, $90.91 at the end of Year 2, and $100 at the end of Year 3. However, since the only time the floor may require a
payment is at the end of Year 3, the amount of the beneficial interest is $100. In applying paragraph 40(b), the option pertains to a nonderivative financial instrument with a notional amount of $100 and, thus, the floor conforms to paragraph 40(b).

Application of Statement 133 to Qualifying SPEs under Statement 140

6. Q—If a formerly qualifying SPE, in applying the provisions of Statement 133 as amended by Statement No. 14X, Amendment of Statement 133 on Derivative Instruments and Hedging Activities, fails one or more of the conditions for being a qualifying SPE under Statement 140, are there any circumstances under which that SPE can continue to be accounted for as qualifying?

A—As amended by paragraph 37 of Statement 14X, paragraph 25 of Statement 140 permits a formerly qualifying SPE, that after the initial application of Statement 14X would not meet the requirements to be a qualifying SPE, to continue to be considered qualifying if it meets the requirements of paragraph 25 as amended.