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FASB Issues FSP Requiring Enhanced Disclosure for Credit Derivative and Financial Guarantee Contracts

by Mark Bolton and Shahid Shah, Deloitte & Touche LLP

The FASB recently issued FSP FAS 133-1 and FIN 45-4,¹ which amends and enhances the disclosure requirements for sellers of credit derivatives (including hybrid instruments that have embedded credit derivatives) and financial guarantees. The new disclosures must be provided for reporting periods (annual or interim) ending after November 15, 2008, although earlier application is encouraged. The FSP also clarifies the effective date of Statement 161.²

The FSP defines a credit derivative as a “derivative instrument (a) in which one or more of its underlyings are related to the credit risk of a specified entity (or a group of entities) or an index based on the credit risk of a group of entities and (b) that exposes the seller to potential loss from credit-risk-related events specified in the contract.” In a typical credit derivative contract, one party makes payments to the seller of the derivative and receives a promise from the seller of a payoff if a specified third party or parties default on a specific obligation. Examples of credit derivatives include credit default swaps, credit index products, and credit spread options.

The popularity of these products, coupled with the recent market downturn and the potential liabilities that could arise from these conditions, prompted the FASB to issue this FSP to improve the transparency of disclosures provided by sellers of credit derivatives. Also, because credit derivative contracts are similar to financial guarantee contracts, the FASB decided to make certain conforming amendments to the disclosure requirements for financial guarantees within the scope of Interpretation 45.³

Credit Derivative Disclosures

The FSP amends Statement 133⁴ to require a **seller** of credit derivatives, including credit derivatives embedded in hybrid instruments, to provide certain disclosures for each credit derivative (or group of similar credit derivatives) for each statement of financial position presented. These disclosures must be provided even if the likelihood of having to make payments is remote. Required disclosures include:

¹ FASB Staff Position No. FAS 133-1 and FIN 45-4, “Disclosures About Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161.”

² FASB Statement No. 161, *Disclosures About Derivative Instruments and Hedging Activities*.

³ FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*.

⁴ FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

- The nature of the credit derivative, including:
 - o The approximate term of the derivative.
 - o The reason(s) for entering into the derivative.
 - o The events or circumstances that would require the seller to perform under the derivative.
 - o The status of the payment/performance risk of the derivative as of the reporting date. This can be based on a recently issued external credit rating or an internal grouping used by the entity to manage risk. (If an internal grouping is used, the entity also must disclose the basis for the grouping and how it is used to manage risk.)
- The maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative contract (or the fact that there is no limit to the maximum potential future payments). If a seller is unable to estimate the maximum potential amount of future payments, it also must disclose the reasons why.
- The fair value of the derivative.
- The nature of any recourse provisions and assets held as collateral or by third parties that the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative contract.

For hybrid instruments that have embedded credit derivatives, the required disclosures should be provided for the entire hybrid instrument, not just the embedded credit derivative.

Financial Guarantee Disclosures

As noted previously, the FASB did not perceive substantive differences between the risks and rewards of sellers of credit derivatives and those of financial guarantors. With one exception, the disclosures in Interpretation 45 were consistent with the disclosures that will now be required for credit derivatives. To make the disclosures consistent, the FSP amends Interpretation 45 to require guarantors to disclose “the current status of the payment/performance risk of the guarantee.”

Effective Date and Transition

Although it is effective for reporting periods ending after November 15, 2008, the FSP requires comparative disclosures only for periods presented that ended after the effective date. Nevertheless, it encourages entities to provide comparative disclosures for earlier periods presented.

Effective Date of Statement 161

After the issuance of Statement 161, some questioned whether its disclosures are required in the annual financial statements for entities with noncalendar year-ends (e.g., March 31, 2009). To address this confusion, the FSP clarifies that the disclosure requirements of Statement 161 are effective for quarterly periods beginning after November 15, 2008, and fiscal years that include those periods. However, in the first fiscal year of adoption, an entity may omit disclosures related to quarterly periods that began on or before November 15, 2008. Early application is encouraged.

Example

An entity has a fiscal year that ends on March 31, 2009. In its annual report for the year ended March 31, 2009, the entity must provide the Statement 161 disclosures for its fourth-quarter interim period ending March 31, 2009, since that quarter began after November 15, 2008.

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