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Revised Proposal to Clarify Embedded Credit-Derivative Scope Exception

Embedded credit-derivative features related only to the transfer of credit risk in the form of subordination of one financial instrument to another would not be subject to potential bifurcation and separate accounting under a revised FASB proposal.¹ Other embedded credit-derivative features would require further analysis to determine whether they must be accounted for separately.² The proposed clarification provides guidance on whether bifurcation and separate accounting would be required for embedded credit-derivative features in financial instruments issued by structures such as collateralized debt obligations (CDOs) and synthetic CDOs.

The proposal revises proposed DIG Issue C22 that was issued for comment in January 2009.³ Comments on the proposal are due November 12, 2009.

Proposed Approach

The FASB believes that the embedded credit-derivative scope exception in Statement 133 has been applied more broadly than originally intended.⁴ The proposal clarifies that the scope exception applies only to an embedded credit-derivative feature that relates to subordination between tranches of debt issued by an entity. Any other embedded credit-derivative feature, such as a written credit default swap, must be evaluated for separation as an embedded derivative. Determining whether the embedded credit-derivative feature is clearly and closely related to the host contract would be one of the factors evaluated.

Embedded credit-derivative features would be evaluated in the following manner:

- CDO: A special-purpose entity holds fixed-rate bonds and issues multiple tranches of fixed-rate debt instruments with differing levels of subordination. Because the embedded credit-derivative feature is created only by the subordination between tranches, the feature would meet the embedded credit-derivative scope exception and would not be evaluated for separation.

¹ FASB Proposed Accounting Standards Update, Scope Exception Related to Embedded Credit Derivatives, available at www.fasb.org.

² FASB ASC Section 815-15-25, Derivatives and Hedging, Embedded Derivatives-Recognition, and paragraph 815-10-15-11 (Statement 133, Accounting for Derivative Instruments and Hedging Activities), available at www.fasb.org.

³ Proposed DIG Issue C22, "Scope Exceptions: Exception Related to Embedded Credit Derivatives," available at www.fasb.org.

⁴ FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (FASB ASC Topic 815), available at www.fasb.org.



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- **Fully Funded Synthetic CDO:** A special-purpose entity that holds U.S. Treasury securities and a written credit default swap on a referenced credit issues multiple tranches of credit-linked debt instruments with differing levels of subordination. The tranche holders are not required to make additional payments to the entity if losses under the credit default swap exceed the value of assets held by the entity. The embedded credit-derivative feature related to the subordination between tranches would meet the embedded credit-derivative scope exception and would not be evaluated for separation. However, the embedded credit-derivative feature related to the written credit default swap would be evaluated for separation.
- **Partially Funded Synthetic CDO:** A special-purpose entity that holds U.S. Treasury securities and a written credit default swap on a referenced credit issues multiple tranches of credit-linked debt instruments with differing levels of subordination. The investors in the residual and mezzanine tranches may be required to make additional payments to the entity if losses under the credit default swap exceed the value of assets held by the entity. Those tranche holders would evaluate all embedded credit-derivative features (related to subordination and the written credit default swap) for separation because the tranche holders' potential future payments are related to credit risk that is not created solely by subordination. However, the tranche holders that are not exposed to potential future payments would evaluate the embedded credit-derivative features similar to a fully funded synthetic CDO.

The proposal also provides additional guidance about whether the economic characteristics and risks of an embedded derivative are clearly and closely related to the host contract.

Practical Impact

Investors in fully funded synthetic CDOs apply the embedded credit-derivative scope exception to their interests in securitized assets and liabilities and do not evaluate the embedded credit-derivative feature for separation. If finalized, this proposal would change current practice because investors would be required to analyze the embedded credit-derivative feature related to the written credit default swap as an embedded derivative. Because the economic characteristics and risks of this embedded credit-derivative feature are not clearly and closely related to the host contract (generally U.S. Treasury securities), the investors would be required to bifurcate and separately account for the feature as a derivative.

Effective Date and Transition

The proposed guidance would be effective the first day of a company's fiscal quarter beginning after December 15, 2009. Companies initially adopting the final requirements would have to assess each currently recognized financial instrument that was acquired, issued, or subject to a remeasurement event on or after Statement 155 became effective (January 1, 2007, for calendar-year-end companies) to determine whether the instrument contains embedded credit derivatives that no longer qualify or now do qualify for the credit-derivative scope exception.⁵

⁵ FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments* (FASB ASC paragraphs 815-10-15-11, 815-15-25-11 through 25-13, 815-15-15-8 through 15-9, and 815-15-55-222 through 55-226), available at www.fasb.org.



**This is a publication of KPMG's
Department of Professional Practice
212-909-5600**

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Earlier editions are available at:
www.us.kpmg.com/definingissues

Companies would be able to irrevocably elect to apply the fair-value option to hybrid financial instruments that otherwise would be separated into a host contract and a derivative instrument upon adoption of the proposal. This election may be made on an instrument-by-instrument basis. If a company does not apply the fair-value option to a hybrid contract that requires separation, the carrying amount of the host contract at adoption would be based on a pro forma bifurcation as of the inception of the hybrid contract and the host contract's subsequent accounting to the date of adoption. At initial adoption, any difference between the total recalculated carrying amount of the individual components of the bifurcated hybrid instrument and the carrying amount of the combined hybrid instrument prior to bifurcation would be recognized as a cumulative-effect adjustment to beginning retained earnings. Companies would not restate prior periods.

Companies that previously separated an embedded credit-derivative feature that qualifies for the credit-derivative scope exception under the proposal would record the combined hybrid instrument at the sum of the carrying amounts of the individual components of the previously bifurcated hybrid instrument at the date of adoption.

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