

# Hot Topic

Update on major accounting  
and auditing activities

## FASB re-exposes proposed amendment to embedded credit derivative scope exception of Topic 815<sup>1</sup>

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### Summary

On 13 October 2009, the Financial Accounting Standards Board (FASB) re-exposed its Proposed Accounting Standards Update, *Scope Exception Related to Embedded Credit Derivatives* (proposed ASU) for public comment. In the revised exposure draft, the FASB clarified the exception from the general requirements to bifurcate embedded derivatives in paragraph 815-15-15-9 (formerly paragraph 14B of Statement 133<sup>2</sup>). Specifically, the FASB clarified that the scope exception is applicable only to embedded credit derivative features between tranches of beneficial interests in securitized financial assets arising from a transfer of credit risk in the form of subordination of one beneficial interest to another tranche of a securitization. Pursuant to the proposed revisions, embedded credit derivative features that expose a tranche holder to making potential future payments, or those that are related to credit default swaps held by the special purpose entity (SPE), are not exempt from further bifurcation analysis

under paragraph 815-10-15-11 and Section 815-15-25 (formerly paragraphs 12 and 14A of Statement 133).

This proposed ASU will change the practice of applying the scope exception under paragraph 815-15-15-9 more broadly to many beneficial interests in securitized financial instruments, including those that had no subordination (i.e., single-tranche securitizations). The revised guidance would require investors in synthetic collateralized debt obligations (CDOs), including both fully funded synthetic CDOs and partially funded synthetic CDOs (refer to our 16 January 2009 Hot Topic<sup>3</sup>), to bifurcate the embedded credit derivative features related to the written credit default swap, or alternatively, elect the fair value option for the entire hybrid instrument. The proposed ASU would have a more sweeping effect on the accounting and reporting for these embedded credit derivatives than was previously proposed in Statement 133 Implementation Issue No. C22, *Scope Exception: Exception Related to Embedded Credit Derivative* (Proposed DIG C22). This

<sup>1</sup> FASB ASC Topic 815, *Derivatives and Hedging*

<sup>2</sup> FASB Statement No. 133, *Accounting for Derivatives and Hedging Activities*

<sup>3</sup> Hot Topic No. 2009-02, *FASB proposes to clarify the embedded credit derivative scope exception of Statement 133*

revised accounting guidance will be a major accounting change for many synthetic CDO investors (e.g., insurance companies) that have historically applied the scope exception to their investments in synthetic CDOs.

The proposed ASU also amends and adds illustrative examples to provide guidance on the application of paragraph 815-10-15-11 and Section 815-15-25 in light of the proposed revisions, including illustrative analyses of whether the economic characteristics and risks of the embedded derivative features are “clearly and closely related” to the economic characteristics and risks of the host contract. In addition, the proposed ASU provides guidance on the application of paragraph 815-15-25-1(a) (formerly paragraph 12(a) of Statement 133) and amends examples that do not involve embedded credit derivatives.

The effective date of the proposed ASU is the first day of a reporting entity’s first fiscal quarter beginning after 15 December 2009.

## Further discussion

### Background

As previously discussed in our 16 January 2009 Hot Topic, on 14 January 2009, the FASB released for public comment Proposed DIG C22 to clarify when embedded credit derivatives, including those in CDOs and synthetic CDOs, are not considered embedded derivatives that must be separately analyzed for potential bifurcation and separate accounting at fair value with changes reported in earnings. The objective of the proposed DIG issue was to clarify the extent of the scope exception under paragraph 815-15-15-9 for embedded credit derivative in hybrid instrument issued by SPEs.

Since then, Proposed DIG C22 has been the subject of extensive redeliberation and discussion by the FASB. During the public comment process, many constituents concurred with how the FASB applied the scope exception to synthetic CDOs as illustrated in the additional examples provided

in the proposed DIG issue, which did not appear to be different from how constituents had always interpreted the scope exception provided by paragraph 815-15-15-9. What was not clearly communicated in Proposed DIG C22, and what did not surface until the redeliberations, is how the FASB viewed the application of the scope exception with respect to a fully funded *single-tranche* structure in which the SPE holds low risk or risk-free assets (e.g., U.S. Treasuries) and a written credit default swap on an unrelated reference entity. Historically, constituents have applied the “clearly and closely related” principle in paragraphs 815-15-25-11 through 25-13 (formerly paragraph 14A of Statement 133) to a fully-funded *single-tranche* (or *multi-tranche*) structure (see further discussion below) and concluded that there was not an embedded credit derivative related to the written credit default swap that requires bifurcation and separate accounting.

Subsequent FASB meetings clarified the FASB’s view about the application of the scope exception to synthetic CDO structures in which a freestanding credit derivative (e.g., credit default swap) exists in the SPE. At its 3 June 2009 meeting, the FASB agreed that the scope exception in paragraph 815-15-15-9 should apply only to the credit derivative features that are created by the subordination of one beneficial interest to another tranche of a securitization.

At that meeting, the FASB decided to re-expose the proposed revisions to the embedded credit derivative scope exception. It also decided to provide additional guidance on the application of Section 815-15-25 (formerly paragraphs 12, 13 and 14A of Statement 133) to embedded derivative features in the examples.

### Clarification of the credit derivative scope exception

The proposed ASU clarifies the FASB’s intent with respect to the extent of the scope exception under paragraph 815-15-15-9. Specifically, only embedded credit

derivatives resulting from transfers of credit risk between the tranche holders that creates the subordination need not be analyzed for potential bifurcation from the host contract and separate accounting as a derivative. All other embedded credit derivative features are subject to the application of paragraph 815-10-15-11 and Section 815-15-25, including analysis of whether the economic characteristics and risks of the embedded credit derivative features are “clearly and closely related” to the economic characteristics and risks of the host contract (provided that the overall contract is not a derivative in its entirety under Section 815-10-15 (paragraph 6 of Statement 133)).

The proposed ASU further provides that the following circumstances would not qualify for the scope exception:

- ▶ If, under the terms of the beneficial interests, the holder of a beneficial interest is exposed to the possibility (however remote) of being required to make potential future payments (not merely receive reduced cash inflows), then any transfer of credit risk to that tranche could not be considered to be only in the form of subordination of one financial instrument to another. Consequently, the scope exception would not apply to that tranche. (This provision is similar to that originally exposed in Proposed DIG C22.)
- ▶ An interest in a single-tranche securitized instrument contains no transfer of credit risk that is only in the form of subordination of one financial instrument to another and, thus, the beneficial interest in a single-tranche securitization is subject to the application of paragraph 815-10-15-11 and Section 815-15-25 for potential bifurcation. (This provision is new.)

The FASB emphasized that credit risk related features that do not result solely from the subordination of one beneficial interest to another tranche of a securitization must be evaluated under paragraph 815-10-15-11

and Section 815-15-25. The proposed ASU identifies different credit risk related features that are typically embedded in the beneficial interests of a synthetic CDO and clarifies that only the “waterfall” credit feature created by allocating the credit exposures between tranches due to subordination in the beneficial interests of the structure is exempt from further bifurcation analysis under paragraph 815-10-15-11 and Section 815-15-25.

With respect to other embedded credit derivative features (such as a credit default swap written by the SPE) in a synthetic CDO in which the credit derivative is used to synthetically create credit exposure to reference assets that the SPE does not hold, the FASB clarified that the scope exception is not intended to apply. As such, further bifurcation analysis under paragraph 815-10-15-11 and Section 815-15-25 will be required. Furthermore, the additional examples provided in the proposed ASU indicate that the bifurcation analysis should not be different between a single-tranche and a multiple-tranche CDO structures. These examples indicate that the existence of any freestanding credit derivatives held by the SPE would require the holders of the beneficial interests to bifurcate an embedded credit derivative related to the freestanding credit derivative from the beneficial interest (a hybrid instrument), because the embedded credit derivative is not considered “clearly and closely related” to the host contract (the element of an asset held by the SPE). This change would affect the accounting for beneficial interests in securitization structures that hold freestanding credit derivatives.

The embedded credit feature that exposes an investor to making potential payments (not merely a potential reduction in future cash inflows), although not widespread but evidenced in a partially funded synthetic CDO structure, has always been thought of as an embedded derivative that requires bifurcation and separate accounting from

the host contract. Therefore, the proposed ASU would not constitute a change in practice in the accounting for these embedded credit derivatives.

#### **Application of the “clearly and closely related” principle**

The FASB amended and added examples in the proposed ASU to illustrate the application of the “clearly and closely related” notion in paragraph 815-15-25-1(a) to provide additional guidance regarding the application of Section 815-15-25. These examples illustrate the FASB’s views on particular securitization structures and whether embedded derivatives exist that may potentially require bifurcation by the holders of the beneficial interests. Although the proposed ASU does not amend Section 815-15-25, these revised and new examples illustrate a different approach in how to apply the “clearly and closely related” principle with respect to the bifurcation analysis of hybrid beneficial interests of a securitization structure.

Currently, application of the “clearly and closely related” principle to beneficial interests of SPEs is based on whether the SPE issuer is capable of providing the necessary cash flows to the beneficial interest holder, as defined by the stated terms of the beneficial interest hybrid instrument. Under present practice, it does not matter whether the credit risk exposure transferred to the beneficial interest investor is achieved because the SPE actually owns the debt obligations at risk of default, or because the SPE owns a credit derivative that references those same debt obligations. When an SPE is not capable of providing the necessary cash flows, different tranches of beneficial interests essentially exchange cash flows with each other, evidencing an embedded derivative that may need to be bifurcated. If the SPE is capable of providing the necessary cash flows, then there is not any implied derivative arrangement among tranche holders in the structure that would warrant bifurcation.

However, in the proposed guidance, the application of the “clearly and closely related” principle now requires the beneficial interest holders to identify the host contract “inside the SPE” by “looking through to” the assets held by the SPE. The interest holder must then compare the economic characteristics and risks of the derivatives inside the SPE to those of the host contract, also inside the SPE, to determine whether an embedded derivative that may require bifurcation exists in the hybrid beneficial interest that the SPE has issued.

Paragraph 815-15-25-11 provides that the holder of a beneficial interest shall determine whether the interest is freestanding derivative or contains an embedded derivative that may require bifurcation and separate accounting from the host contract under Section 815-15-25. Previously, the host contract was determined by analyzing the terms of the beneficial interests issued by the entity. However, the proposed ASU focuses on the nature of the assets held by the issuing entity in determining the host contract to be used in the “clearly and closely related” analysis. Under this approach, challenges may result when attempting to identify the host contract in a CDO structure in which the SPE holds a portfolio of bonds of different underlying issuers. The question becomes which one of the bonds inside the SPE should be defined as the host contract?

It is clear in the proposed examples that the application of the “clearly and closely related” principle would now result in different bifurcation results for the hybrid beneficial interests issued by SPEs that hold written credit derivatives versus those issued by SPEs that hold only interest rate derivatives or currency derivatives. It appears that the FASB intends to preserve a non-bifurcation result for most common interest risk and currency risk related embedded features, while carving out a different principle for “writers” of credit derivatives, particularly those that pass credit risk on to the beneficial interest investors.

### **Fair value measurement of embedded credit derivatives**

The proposed ASU would expand the scope of embedded credit derivatives that would likely be bifurcated and accounted for separately by beneficial interest holders. Companies could be faced with challenges in measuring the fair value of bifurcated credit derivatives, particularly those existing in a multiple-tranche synthetic CDO structure. In some cases, multiple embedded credit derivative features may exist in the structure that would require bifurcation of a compound derivative from the hybrid beneficial interests (e.g., a multiple-tranche partially funded synthetic CDO structure).

As an example, in a multiple-tranche synthetic CDO, investors in each tranche would be required to account separately for the embedded credit derivative feature related to the written credit default swap held by the SPE. Each tranche holder would have to determine the fair value of that bifurcated embedded derivative based on each tranche's portion of the expected future cash flows resulting from that derivative. The determination of the fair value of the embedded credit derivatives is based on the expected cash flow impact as affected by the "waterfall" provisions even though no separate derivative is recognized for the embedded credit derivative feature related to the subordination.

We foresee difficulties in the fair value measurement of these embedded credit derivatives. An inability to measure the embedded credit derivatives might prompt companies to elect to measure the entire beneficial interest (a hybrid instrument) at fair value rather than deal with the complexity of separately accounting for and measuring the fair value of bifurcated credit derivatives.

### **Convergence with IFRS**

It is not the stated objective for this project to achieve convergence with International Financial Reporting Standards (IFRS) regarding when embedded credit derivative features are or are not considered embedded derivatives subject to potential bifurcation and separate accounting. Nonetheless, the result of this proposed guidance would more closely align the present accounting and reporting requirements for embedded credit derivatives under US GAAP and IFRS, particularly for those credit derivatives embedded in the beneficial interests in synthetic CDO structures.

The FASB and the International Accounting Standard Board (IASB) are currently and jointly undertaking a major project on the accounting for financial instruments. One prominent provision within the IASB's recently issued exposure draft<sup>4</sup> would eliminate the requirement to bifurcate embedded derivatives from a financial host contract that is within the scope of this proposed standard. The exposure draft requires all financial instruments, including hybrid contracts with financial hosts, to be presented on the balance sheet at either fair value with changes in value recognized in profit and loss or at amortized cost. Neither of the two methods would require bifurcation of embedded derivative features.

### **Disclosure – credit derivatives**

The proposed ASU amends the disclosure requirements related to sellers of credit derivatives under paragraph 815-10-50-4K (formerly FSP FAS 133-1 and FIN 45-4<sup>5</sup>), which requires disclosures to be provided for both (a) embedded credit derivatives that are bifurcated and separately accounted for

from the host contract and (b) hybrid instruments that have nonbifurcated embedded credit derivatives. The proposed ASU provides an exemption for embedded credit derivative features that meet the scope exception under paragraph 815-15-15-9 (i.e., that result only from subordination of one beneficial interest tranche to another) from the disclosure requirements of paragraph 815-10-50-4K.

### **Effective date and transition**

The effective date of the proposed ASU is the first day of a reporting entity's first fiscal quarter beginning after 15 December 2009.

Upon adoption, an entity is required to evaluate each pre-existing hybrid instrument that was acquired, issued, or subject to a re-measurement (new basis) event occurring on or after the date the entity adopted the guidance in 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 (formerly Statement 155<sup>6</sup>) to determine whether this instrument contains one or more embedded credit derivatives that would no longer qualify for the scope exception under the revised paragraph 815-15-15-9 (provided that the entire instrument is not a derivative pursuant to Section 815-10-15).

The proposed guidance permits an entity to make an irrevocable election to measure at fair value (with changes in fair value recognized in earnings) a hybrid financial instrument in its entirety for which bifurcation of the embedded derivative would otherwise be required upon initial adoption. The fair value election should be determined on an instrument-by-instrument basis and supported by documentation completed by the end of the fiscal quarter of initial adoption. Any difference between the fair value of the hybrid instrument and its previous carrying amount must be

<sup>4</sup> Exposure Draft, *Financial Instruments: Classification and Measurement*

<sup>5</sup> 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*

<sup>6</sup> FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140*

recognized as a cumulative-effect adjustment to beginning retained earnings for the period of adoption.

If the fair value election is not made for the instrument, the carrying amount of the host contract at adoption would be based upon a pro forma bifurcation of the hybrid instrument as of its inception. That is, the entity must calculate the current carrying amount of the host contract and bifurcated derivative as if they had been bifurcated since acquisition. At adoption, any difference between the total carrying amount of the individual components of the

newly bifurcated hybrid instrument and the carrying amount of the hybrid instrument prior to bifurcation should be recognized as a cumulative effect adjustment to beginning retained earnings for the period of adoption.

For any contract containing embedded derivative features that have previously been bifurcated but are no longer subject to bifurcation under the scope exception in the revised guidance, the carrying amount of the combined hybrid instrument at adoption should be the total carrying amount of the individual components of the preexisting bifurcated hybrid instrument. No

cumulative-effect adjustment to the beginning retained earnings for the period of adoption would be warranted.

In addition, the proposed ASU would require an affected entity to separately disclose the gross gains and losses that make up the cumulative-effect adjustment, determined on an instrument-by-instrument basis. Prior periods should not be restated.

Interested parties wishing to comment should do so by 12 November 2009.

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