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## Alert

## Proposed Clarification of Credit-Derivative Scope Exception

The FASB proposed amending Statement 133 to clarify when embedded credit-derivative features, including those in collateralized debt obligations (CDOs) and synthetic CDOs, are not embedded derivatives subject to potential bifurcation and separate accounting.<sup>1</sup> The proposal holds that an embedded credit-derivative feature related only to the concentration of credit risk in the form of subordination of one financial instrument to another is not an embedded derivative that is subject to Statement 133. Other embedded credit-derivative features would have to be further analyzed under Statement 133 to determine whether they must be accounted for separately, a requirement that specifically includes analyzing whether the embedded credit-derivative feature is clearly and closely related to the host contract.

Comments on the proposal are due February 13, 2009.

### Transition

The proposed guidance would be effective the first day of a company's fiscal quarter beginning after December 15, 2008 (January 1, 2009, for calendar-year-end companies). Companies initially adopting the proposal's guidance would have to assess each currently recognized financial instrument that was acquired or issued on or after Statement 155 became effective (January 1, 2007, for calendar-year-end companies) to determine, as of the date of initial adoption, whether the contract contains embedded credit derivatives that no longer qualify for the scope exception in paragraph 14B of Statement 133.<sup>2</sup>

Companies may apply the fair-value option to hybrid financial instruments that would be separated into a host contract and a derivative instrument as a result of adopting the guidance in the proposed DIG Issue. If a company does not apply the fair-value option to a hybrid contract that would be required to be separated under the proposed guidance, 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 on the host contract's subsequent accounting to the date of adoption.

Any difference, at initial adoption, between the total carrying amount of the individual components of the bifurcated hybrid instrument and the carrying amount of the combined

<sup>1</sup> Proposed DIG Issue C22, "Scope Exceptions: Exception Related to Embedded Credit Derivatives," and FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998, as amended, both available at [www.fasb.org](http://www.fasb.org).

<sup>2</sup> FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments, available at [www.fasb.org](http://www.fasb.org).



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hybrid instrument prior to bifurcation would be recognized as a cumulative-effect adjustment to beginning retained earnings. Companies would not restate prior periods.

**Two Examples from the Proposal**

Partly in response to constituents' questions about the application of the scope exception in paragraph 14B to embedded credit-derivative features in CDOs and synthetic CDOs, the proposed DIG Issue provides two new examples to illustrate the breadth and application of the paragraph 14B scope exception. Both are reproduced verbatim below.

**Example 39: Partially Funded Synthetic CDO.** An SPE [special purpose entity] that holds GICs [guaranteed investment contracts] and that wrote a credit default swap on a referenced credit to a third party, with a significantly larger notional amount than the GICs, issues various tranches of credit-linked beneficial interests to investors that differ in terms of priority and in their potential obligation to fund any losses on the credit default swap. That is, if credit losses greater than the value of the GICs are incurred under the credit default swap, the investors in one or more tranches may be required to provide additional funds to the special purpose entity, which would then be passed on as payments to the holder of the credit default swap. Under paragraph 14B (as revised), the investor's embedded credit derivative feature that relates only to the concentration of credit risk in the form of subordination of one tranche to another is not an embedded derivative subject to the application of paragraphs 12, 13, and 14A of Statement 133. However, the tranches that expose the investor to making potential payments related to defaults on the written credit default swap would contain an embedded derivative subject to the application of paragraphs 12, 13, and 14A (provided that the investor's overall contract is not a derivative in its entirety under paragraph 6 of Statement 133). While the risk in those tranches is credit-related, the investor can lose more than its original investment. Therefore, the credit risk is not related only to subordination and must be evaluated under paragraphs 12, 13, and 14A. Because the credit default swap relates to a referenced credit and could expose the investor to potential payments (not merely reduced cash inflows), the swap's credit risk is not related to the risk of simply failing to receive cash inflows from the referenced credit; thus, the economic characteristics and risks of the credit default swap would not be clearly and closely related to the economic characteristics and risks of the host contract.

**Example 40: Fully Funded Synthetic CDO.** An SPE that holds U.S. Treasury securities and that wrote a credit default swap on a referenced credit to a third party, with a smaller notional amount than the U.S. Treasury securities, issues various tranches of credit-linked beneficial interests to investors that differ in terms of priority for the distribution of cash flows from the SPE. The assets in the SPE are sufficient to fund any losses on the credit default swap. Thus, none of the tranches expose the investor to potential future payments related to defaults on the written credit default swap; the investor cannot lose more than its original investment. Rather, the investor is exposed to a potential reduction in its future cash inflows, which is the effect of the credit-related risk. That reduction in future cash flows is allocated among the tranches by the subordination of one tranche to another. Under paragraph 14B (as revised), the investor's embedded credit derivative feature is not an embedded derivative subject to the application of paragraphs 12, 13, and 14A of Statement 133 because it relates only to the concentration of credit risk in the form of subordination of one tranche to another.

The descriptive and summary statements in this newsletter are not intended to be a substitute for the requirements of Proposed DIG Issue C22 or any other applicable or potential accounting literature or SEC regulations. Companies applying GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.