

## **Q&As on accounting for some collateralised debt obligations (CDOs) – prepared by the staff of the IASB**

The following questions and answers (Q&As) summarise some key issues regarding the accounting for some CDOs in accordance with International Financial Reporting Standards (IFRSs) and highlights at a summary level how that compares to US generally accepted accounting principles (GAAP). The summary reflects the IASB's discussions on this issue and updates provided by the IASB staff to the Board. The summary has been prepared by the staff of the IASB.

### **1. What is the issue?**

Some features of collateralised debt obligations (CDOs) are embedded credit derivatives. The issue is: when do these embedded credit derivatives have to be separated from the CDOs and accounted for at fair value through profit or loss?

This issue was raised by some participants in the public round tables held in November and December 2008 in response to the global financial crisis as well as by other commentators in letters to the IASB.

### **2. What is a CDO?**

A collateralised debt obligation (CDO) is a type of an asset-backed security. It could also be described as a form of structured credit product. CDOs can be issued by different types of entities but typically the issuers are special purpose entities (SPEs). There are various types of CDOs reflecting differences in aspects such as:

- the design of different CDO tranches with different credit risk (eg using so called 'waterfall' features that allocate the credit exposure between different tranches);
- how the credit risk is generated. For example, directly by the issuer investing in assets with the target credit risk (so called 'cash CDOs'), or indirectly by creating the target credit risk synthetically through a combination of low risk or 'risk free' investments and credit derivatives (so called 'synthetic CDOs' - an example is an SPE that invests in treasury bonds and then increases its credit exposure by entering into credit default swaps);
- whether tranches are funded or unfunded.

### **3. What is the IFRS accounting for embedded credit derivatives in CDOs?**

The main accounting issue regarding the credit risk associated with CDOs is whether there are features that constitute embedded credit derivatives that must be separated from the CDOs and accounted for at fair value through profit or loss (ie in the same

way as other derivatives). Two main features of CDOs are important in this respect for IFRSs:

- (a) the so called ‘waterfall’ feature that allocates the credit exposure between different tranches (refer to Question 2).
- (b) the location of the reference asset. This is about who is the holder of the reference assets the credit risk of which is reflected in the CDOs. For example, if the credit risk is generated synthetically (refer to Question 2) the issuer of the CDO does not own the reference assets.

The IASB staff agenda paper ([paper 6E](#)) presented to the IASB in December 2008 noted that under IFRSs:

- ‘waterfall’ features generally do not result in the separation of an embedded credit derivative from the CDO.
- for CDO structures with issuers that do not hold the reference assets but instead create credit exposure to the reference assets by using credit derivatives such as credit default swaps (CDSs) an embedded credit derivative is separated from the CDO (unless the entire CDO is classified as fair value through profit or loss).

IFRSs include explicit guidance on the issue of the location of the reference asset in paragraph AG30(h) of IAS 39 *Financial Instruments: Recognition and Measurement*. This guidance explains whether the economic characteristics and risks of the embedded credit derivative are closely related to the economic characteristics and risks of the CDO. If they are closely related, they are not separated.

#### **4. Are there differences between IFRSs and US GAAP regarding the accounting for embedded credit derivatives in CDOs?**

IFRSs and US GAAP have different approaches to the assessment of embedded derivatives. The key questions regarding the separation of embedded credit derivatives from CDOs in accordance with IFRSs are:

- whether a separate instrument with the same terms as a credit-risk related feature of the CDO would meet the definition of a derivative (ie whether there is an embedded derivative); and, if so,
- whether the economic characteristics and risks of the embedded derivative are closely related to the economic characteristics and risks of the host contract.

By contrast, US GAAP deals with embedded credit derivatives from CDOs as follows:

- the concentration of credit risk in the form only of subordination of one financial instrument to another (‘waterfall’ feature) is exempted from the embedded derivative accounting requirements, and
- other features are subject to the general embedded derivative accounting requirements, which include similar criteria to those described for IFRSs above.

In addition, the accounting for host contracts after separation of an embedded credit derivative would be subject to different requirements under IFRSs and US GAAP.

Both IFRSs and US GAAP are each comprehensive bases of financial reporting. This results in complex interactions within each system that can have different impacts, even on very similar or converged individual requirements. For example, US GAAP has specific requirements for fair value measurement of many beneficial interest investments and uses different impairment tests than IFRSs (for example, securities under US GAAP are subject to a fair value impairment model that permits no subsequent reversals of losses, unlike IAS 39).

Consequently, convergence on the accounting for CDOs could not simply be achieved by changing the IFRS guidance on embedded credit derivatives but would require far more extensive and significant changes to the accounting for financial instruments in accordance with IFRSs, in particular expanding the mandatory use of fair values for hybrid financial assets for which embedded derivatives are not separately accounted for. Thus, even in scenarios that result in the same outcome of the assessment of embedded credit derivatives there could still be different accounting outcomes for CDOs.

The Financial Accounting Standards Board (FASB) is currently deliberating the Proposed Statement 133 Implementation Issue No. C22 (proposed DIG C22). Some of the comment letters submitted alerted the FASB to the issue of convergence between US GAAP and IFRSs. Those comment letters indicate that the proposed DIG C22 may not achieve full convergence. It would be premature to assess the consistency between US GAAP and IFRSs regarding the accounting for credit derivatives embedded in CDOs before the proposed requirement is finalised.

## **5. When has the IASB discussed this issue?**

As noted previously, the IASB discussed the accounting for credit derivatives embedded in CDOs in its meetings in November and December 2008.

In February 2009 the staff provided the IASB with an update on this issue. In summary, the IASB staff noted that:

- paragraph AG30(h) of IAS 39 explicitly addresses the issue of the location of the reference assets; and
- there is no diversity in IFRS practice.

The IASB and the FASB have also recently added a major project on recognition and measurement of financial instruments to their respective active agendas. The projects are intended to be run as a joint project of the two boards. Thus, any piece-meal changes to existing IFRSs that are potentially in the scope of the project on recognition and measurement of financial instruments would potentially pre-empt or delay this major project.