



30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: November 2008, London

Project: Financial Instruments

Subject: Accounting for investments in credit-linked financial instrument (Agenda Paper 11B)

Introduction

1. Some have asked how an investor in credit-linked financial instruments should account for such instruments.
2. This paper:
 - (a) describes some of the many different types of credit-linked financial instruments; and
 - (b) sets out some of the accounting considerations for the holder of such instruments that may be relevant.
3. This paper is for background information only, and does not ask the Board for any decisions. As noted in agenda paper 11, given the complexity of the subject matter, the many differing types of credit-linked financial instruments and the requirement for an entity to apply judgement to the required accounting for the particular type of financial instrument they hold, this paper does not seek to provide any technical answers.

Background

4. Some types of financial instruments create an exposure for the holder of the instrument ('investor') to a reference credit that is not the credit risk of the issuer of the instrument. Such instruments, often referred to credit-linked notes, contain features that are similar to those of a (a) non-derivative debt instrument and (b) credit derivative or financial guarantee.
5. Investors in such instruments accept exposure to a reference credit risk other than that of the issuer of the instrument in exchange for a higher yield. Payments to investors are only made if the reference credit does not default. The reference credit to which such instruments are linked may or may not be held by the issuing entity (often a trust or similar vehicle) – although if the CDO vehicle does own the reference assets, given the narrow investment scope of the CDO vehicle, the credit risk of the reference assets and the CDO vehicle will be similar.
6. Collateralised debt obligation (CDO) structures are one example of credit-linked notes (although as noted below there are many different types of CDO structures).
7. The CDO vehicle issues securitised interests in pools of financial assets. The CDO vehicle issues different tranches of beneficial interest securities to investors – for example, senior (rated AAA), mezzanine (AA to BB) and equity (unrated). This offers investors various maturities and credit risk exposures.
8. The cash flows of any underlying assets of the CDO vehicle fund the tranches of beneficial interest securities issued by the CDO vehicle. The priority of payments to the holders of those securities follows the subordination ranking of the tranches (often referred to as the 'cash waterfall'). This means that a senior tranche is paid in full, before any subordinated tranche is paid. Such a waterfall exists for both interest payments and any principal repayment.

9. This subordinated tranche structure means that holders of junior tranches expect to receive higher returns (coupons) than holders of senior tranches.
10. There are different types of CDO structures. Among the more common are:
 - (a) 'cash' CDOs – whereby the CDO vehicle holds the underlying reference assets (for example, loans or debt instruments of a third-party).
 - (b) 'hybrid' CDOs – whereby the CDO vehicle does not directly hold the underlying reference assets but creates the credit exposure to a third-party some other way. For example, such a structure may include (among other things) some non-derivative assets to create a risk-free rate of return (for example, US Treasury bonds) and some form of derivative written credit protection on a reference third-party loan or debt instrument (for example, a credit default swap). Writing such protection generates premium for the CDO vehicle.
 - (c) 'synthetic' CDOs – whereby the CDO vehicle creates the credit exposure only by using derivatives to write credit protection and generate premium (for example, a credit default swap). Synthetic CDOs may include some unfunded tranches whereby the investors in unfunded tranches only have to provide funding to the CDO structure in the event of credit losses to the unfunded tranche. The proceeds from any funded tranches (normally the most subordinated) are typically invested in high-quality, liquid assets or Guaranteed Investment Contracts (GICs) to generate a LIBOR-related return. This return is used to pay interest to the funded tranches.
11. This is not an exhaustive list of CDO structures. For example, CDO-squared transactions have been relatively popular. Such structures are typically leveraged single-tranche CDOs in which the underlying assets are CDO tranches or a mixed pool of CDO tranches and Asset Backed Securities (ABSs). The leverage and correlation features of such structures created different risk profiles for investors, with significantly greater income pick-up

compared to more traditional CDO structures for investors in the most junior tranches (at origination of the CDO structure, at least!).

12. Investments in instruments issued by CDO vehicles may include and combine contractual features that result in many different exposures for the investor that may be important for any analysis of how the investor accounts for the financial asset.
13. For example, the most relevant feature of a financial instrument issued by a cash CDO vehicle (that holds the loans or debt instruments issued by a third-party to which the instruments issued by the CDO vehicle are linked) may be the effects of the ‘waterfall’ feature for investors in the different tranches. Other CDO structures may issue instruments that include features that create leverage and other types of exposures for the investors in those instruments.
14. Before continuing, it is worth considering in isolation the ‘waterfall feature’ in a financial instrument issued by a cash CDO vehicle. One way of looking at the junior tranche is that the investor has assumed other parties’ (the senior tranche investors) risk to the credit risk of the reference assets in consideration for a higher return; that is, the junior tranche has written credit protection to the senior tranche. Likewise, holders of senior tranches can be viewed as having purchased credit protection from the junior tranches.

Some relevant accounting considerations

15. Some have asked how an investor in a financial instrument issued by a CDO vehicle should account for that investment.
16. In determining the accounting of any financial instrument, the terms and conditions of that financial instrument itself are of primary importance. For example, take the accounting of a financial asset held by an investor such as an investment in a mutual fund or similar entity. We do not typically look through to the underlying assets held by the mutual fund in determining the investor’s accounting. We look at the terms and conditions of the investors’ financial asset (as well as the investors’ intent in some situations).

17. Paragraphs from IAS 39 that may be relevant to any accounting analysis of the financial asset held by an investor in a CDO vehicle are discussed below and are replicated in full in appendix one.

The four categories of financial instruments

18. IAS 39 has four categories of financial instruments, as defined in paragraph 9 of the standard, with accompanying application guidance in paragraphs AG14 to AG26. The category into which an instrument (or part of an instrument) is placed determines the subsequent accounting for that instrument (or part of that instrument).
19. The staff believes it important to note that some types of investments in financial instruments issued by a CDO vehicle in their entirety may meet the definition of a derivative – for example, some unfunded tranches in synthetic CDO structures.

Derivatives and embedded derivatives

20. The requirements and definitions relating to derivatives and embedded derivatives may also be of some relevance.
21. A derivative is defined in paragraph 9 of IAS 39. Paragraphs 10-13 of IAS 39 set out the requirements to assess and separate embedded derivatives (paragraphs AG27-AG33B provide application guidance).
22. Essentially, those paragraphs state that an embedded derivative shall be separated from the host contract and accounted for as a derivative if the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract.
23. Paragraphs AG30 and AG33 provide application guidance on ‘closely related’. The approach taken in IAS 39 is to illustrate the application of ‘closely related’ by a list of examples of embedded features that are considered to be ‘closely related’ and a list of examples of embedded features that are considered to be ‘not closely related’ to the rest of the contract.

24. Unlike FASB literature (see later section), none of the application guidance in IAS 39 relating to embedded derivatives directly addresses the waterfall feature of CDOs discussed earlier in this paper.
25. Paragraph AG30(h) of IAS 39 deals with credit derivatives but it does not address the waterfall subordination feature. However, it does address the separate issue of the *location* of the reference assets whose credit risk is concentrated (that is, whether the CDO vehicle holds the reference assets). The location of the reference assets may be important in the analysis of whether an embedded credit derivative exists. Paragraph AG30(h) seems to be inconsistent with the fact (as noted earlier) that we do not typically look through to the underlying assets held by the issuer of a financial instrument in determining the accounting of the asset held by the investor.
26. Paragraph AG33(a) of IAS 39 relates to features (embedded derivatives) that have an interest rate or an interest rate index as their underlying, and that underlying could change the amount of interest on the interest-bearing host debt contract. Paragraph 33(a) may not always be that relevant because the value of the waterfall feature in an investment issued by a CDO vehicle changes in response to the default risk of the reference assets held by the CDO vehicle (including changes in the pricing of that risk). Moreover, CDOs with fixed returns do not involve changes in the amount of the periodic payments. Even if CDOs have variable returns, the changes in the default risk related to the waterfall feature do not affect the interest but the risk premium received for assuming (or paid for transferring) part of the ‘symmetrical’ credit risk. The staff notes that these payments do not constitute interest, which is a time charge for the use of cash or cash equivalents or amounts due to the lender (see paragraph 5(a) of IAS 18).
27. One possible helpful analogy might be the example in paragraph AG33(e). This relates to the example of interest- and principal-only strips that result from bifurcation of an instrument with an embedded prepayment option.
28. Paragraph AG33(e) states that an embedded prepayment option is closely related to the host contract provided that the host contract (i) initially resulted

from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host contract.

29. The analogy relates to the reallocation of cash flows of an instrument to different interest holders, and implies that such a reallocation results in an assessment that the embedded features are ‘closely related’ to the rest of the contract.
30. That circumstance could be compared to the reallocation of cash flows among investors in different tranches issued by a CDO vehicle arising from the waterfall feature. (The staff notes that the treatment of cash CDOs in FASB literature is predicated on a similar argument, as discussed later in this paper).
31. Finally, the staff notes that for an embedded derivative to be separated out paragraph 11(b) of IAS 39 states that a separate instrument with the same terms as the embedded derivative must meet the definition of a derivative (which is found in paragraph 9 of IAS 39). As noted below, something that meets the definition of a financial guarantee does not meet the definition of a derivative.

Financial guarantee contracts

32. The definition of a financial guarantee contract (FGC) is found in paragraph 9 of IAS 39.
33. The definition of a FGC is based on the notion of a reimbursement for a loss the holder of the guarantee incurs because a specified debtor failed to make payment on its debt instrument when due.
34. An FGC as defined in IAS 39 requires payments to reimburse for an actual incurred loss. More specifically, this means that:
 - (a) because they are reimbursements, the payments to the holder of the FGC must not exceed the loss incurred; and

- (b) the holder of the FGC must have incurred a loss because of the failure of a specified debtor to make payments under the guaranteed debt instrument when due.
- 35. Also of some relevance might be the meaning of ‘a debt instrument’ in the definition of a FGC – and especially whether the term ‘a debt instrument’ includes credit derivatives (and, if not, whether that is important).
- 36. Paragraph AG4 of IAS 39 provides some application guidance – including implying in paragraph AG4(b) that something that meets the definition of a financial guarantee contract (FGC) is not a derivative as defined in paragraph 9 of IAS 39, and should be accounted for according to the requirements relating to FGCs in IAS 39.
- 37. It may also be important to note that:
 - (a) IAS 39 does not permit the separation of the features in a financial instrument that meet the definition of a FGC (unlike the requirement to separate some embedded derivatives), and
 - (b) the definition of a FGC does not require the holder of the FGC to also hold the guaranteed debt instrument as an asset.
- 38. The staff notes that in practice the assessment of whether a feature (on a stand-alone basis) meets the definition of an FGC often involves considerable judgement.

FASB literature

- 39. Paragraph 14B of FASB Statement 133 *Accounting for Derivative Instruments and Hedging Activities* (as amended by FASB Statement 155 *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140*) sets out a specific requirement for particular embedded derivatives in the context of securitisation transactions [emphasis added]:

‘Changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative contracts) that represent the assets or liabilities that are held by the

issuing entity shall not be considered an embedded derivative under this Statement. The concentration of credit risk in the form of subordination of one financial instrument to another shall not be considered an embedded derivative under this Statement.'

40. Based on discussions with the FASB staff, we understand that paragraph 14B in FASB Statement 133 is only intended to address the waterfall issue in the situation that the issuing entity holds the reference assets (for example, in a cash CDO structure).
41. The staff notes that the reasoning in the Basis for Conclusions of FASB Statement 155 (paragraphs A19-A24) only addresses the waterfall issue and that paragraph A24 states:

'The Board noted, however, that other aspects of Statement 133 regarding credit risk and the identification of credit risk as an embedded derivative are not affected by the Board's decision on concentrations of credit risk.'

Appendix 1

Some IFRS requirements that may be relevant

1. Paragraph 9 of IAS 39 (definition of a derivative):
'A *derivative* is a financial instrument or other contract within the scope of this Standard (see paragraphs 2-7) with all three of the following characteristics:
 - (a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');
 - (b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors;
and
 - (c) It is settled at a future date.'

2. Paragraph 9 of IAS 39 (definition of an FGC):
'A *financial guarantee contract* is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.'

3. Paragraph 10 of IAS 39:
'An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other

Appendix 1

variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.’

4. Paragraph 11 of IAS 39:

‘An embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs AG30 and AG33);
- (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

If an embedded derivative is separated, the host contract shall be accounted for under this Standard if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument. This Standard does not address whether an embedded derivative shall be presented separately in the statement of financial position.’

5. Paragraph AG4(b) of IAS 39:

‘Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in this Standard, and are not insurance contracts, as defined in IFRS 4. Such guarantees are derivatives and the issuer applies this Standard to them.’

Appendix 1

6. Paragraph AG30(h) of IAS 39:
‘Credit derivatives that are embedded in a host debt instrument and allow one party (the ‘beneficiary’) to transfer the credit risk of a particular reference asset, which it may not own, to another party (the ‘guarantor’) are not closely related to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.’

7. Paragraph AG33(a) of IAS 39:
‘An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder’s initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.’

8. Paragraph AG33(e) of IAS 39:
‘An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.’

9. Paragraph 5 of IAS 18
‘The use by others of entity assets gives rise to revenue in the form of:
(a) interest—charges for the use of cash or cash equivalents or amounts due to the entity;

Appendix 1

- (b) royalties—charges for the use of long-term assets of the entity, for example, patents, trademarks, copyrights and computer software; and
- (c) dividends—distributions of profits to holders of equity investments in proportion to their holdings of a particular class of capital.’