

# CDO Developments: Accounting Issues

# CDO Accounting Issues

There are many accounting considerations and issues related to CDO structures and they vary depending on the nature of your involvement with structure

Sponsor/ Transferor	Asset Manager	Investor
Consolidation/ FIN 46R FAS 140 – sale criteria	Consolidation/ FIN 46R	Consolidation/ FIN 46R EITF 99-20 OTTI (other than temporary impairment) FSP No. FAS 115-1 and 124-1: The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments

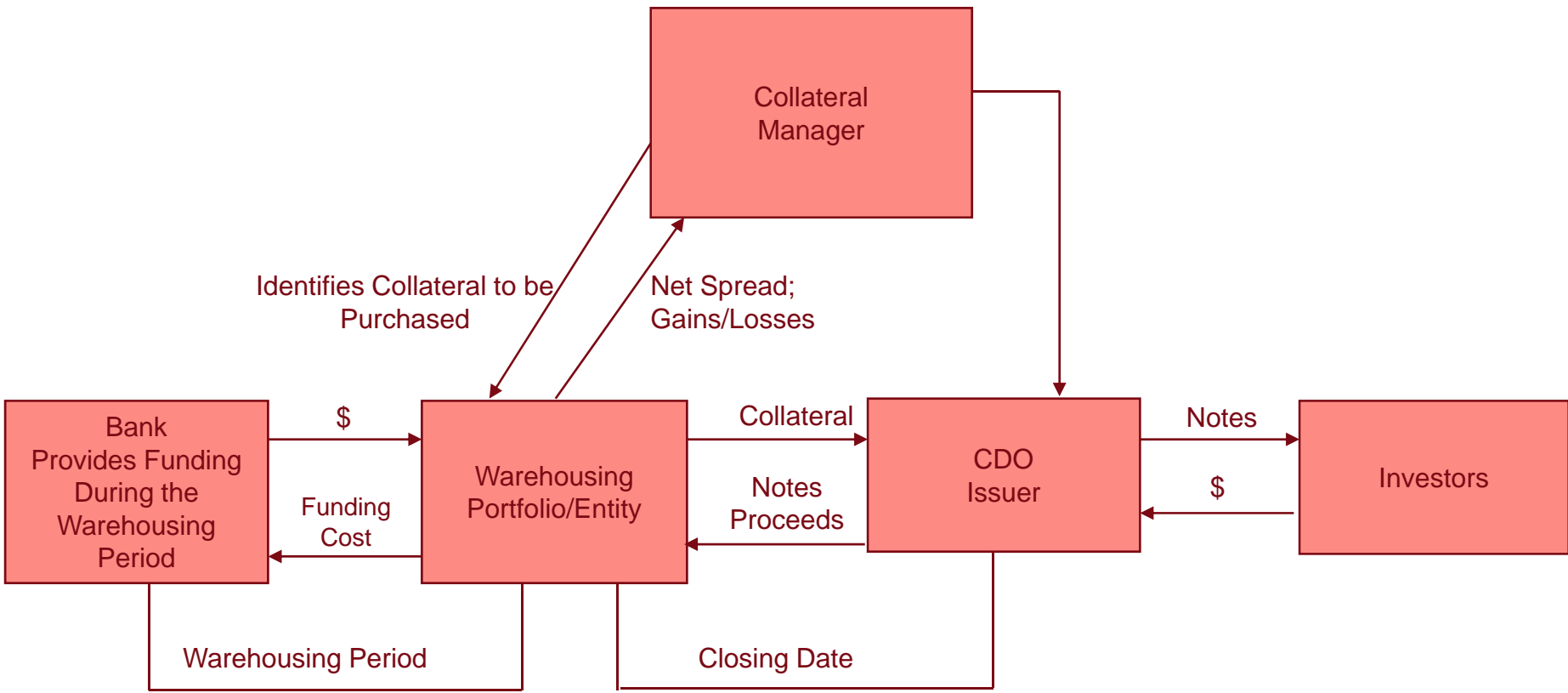
## CDO Developments: Accounting Issues

- Accounting for Transfers of Collateral to CDO Entities: FAS 140 Sales Accounting
- Investor Accounting for CDOs: EITF Issue 99-20

# CDO Developments: Accounting Issues

Accounting for Transfers of Collateral to CDO Entities:  
FAS 140 Sales Accounting Considerations

# Sales Accounting: Typical CDO Warehousing Arrangement



# FAS 140 Sales Accounting Requirements and CDO Structural Attributes

FAS 140 Par. 9 Requirements	Relevant CDO Arrangement
(a) Transferred assets “isolated”	“Would level” true sales/substantive non-consolidation opinion
(b) Transferee has right to pledge and exchange the transferred assets – if constrained, transferor derives no more than a “trivial benefit” from constraint	<ul style="list-style-type: none"> <li>• Collateral pledged at closing date to secure the BIs</li> <li>• Transferor frequently serves as collateral manager</li> </ul>
(c) Transferor cannot retain “effective control” over a transferred asset – via a call option, etc.	Transferor, if the collateral manager, can choose collateral to be sold

## Sales Accounting: Impact of a Free Trade Basket

### Background

Collateral manager (CM) is permitted to sell collateral securities up to a certain percentage of the aggregate principal balance per annum (typically, 15% - 20%) (the “free trade basket”) during reinvestment period. CM can also sell collateral in limited circumstances

### Issue

Can the “free trade basket” be considered sufficient to meet the paragraph 9(b) test?

### Views

- Yes. In a substantive “free trade basket” arrangement, the CM can dispose of any one security at any point in time
- No. At any point in time, only a portion of the portfolio may be sold – most of the securities remain locked up

# Impact of Transferor Serving as Collateral Manager

## Background

The transferor is the CDO entity's collateral manager

## Issue

Has the transferor relinquished control over the transferred assets when it serves as CM, and thus retains the right to direct the sales of those assets?

## Views

- A 9(b) problem based on paragraph 29 – transferor retains effective control. No other party can direct the activities of the CDO entity
- Not a 9(b) problem: CM is acting as a fiduciary/agent of the CDO entity's investors, pursuant to a contract

# Sale Accounting: Impact of Transferor Serving as Collateral Manager with Other Powers

## Background

The transferor is the CDO entity's CM and holds a portion of the CDO entity's equity or residual tranche. In addition, the transferor has the right to:

- Participate in an auction or a sale of the transferred assets, and/or
- Acquire any asset put up for sale by matching a fair value price

## Issue

Through these arrangements, does the transferor maintain “effective control” over the asset, thus violating the paragraph 9(c) test?

## Views

- The transferor's involvement in the auction process should be considered
- “Facts and circumstances” analysis

# CDO Developments: Accounting Issues

Investor Accounting for CDOs: EITF Issue 99-20

# Impact of Current Market Disruption on Accounting for Investments in CDOs

- Valuation Methodology
- Write-downs
  - Credit vs. Liquidity?
- Accounting Treatment

## Definition of Fair Value in FAS 157

*Fair value is the price that would be received to **sell** an asset or **paid to transfer** a liability in an **orderly transaction** between **market participants** at the measurement date.*

*(Emphasis Added)*

# FAS 157 Fair Value Hierarchy

Level 1	Level 2	Level 3
<p>Observable inputs that reflect <b>quoted prices for identical</b> assets or liabilities in <b>active</b> markets. The reporting entity must have the ability to access that market at the measurement date.</p>	<p>Directly or indirectly <b>observable</b> inputs other than those included in Level 1, including:</p> <ul style="list-style-type: none"> <li>- Quoted prices for similar assets.</li> <li>- Quoted prices for identical assets in illiquid markets.</li> <li>- Inputs other than quoted prices that are observable for the asset or liability</li> <li>- Inputs that are derived principally from or corroborated by other observable market data through correlation or by other means</li> </ul>	<p><b>Unobservable</b> market inputs that reflect the reporting entity's own assumptions about market participant assumptions used in pricing an asset.</p> <ul style="list-style-type: none"> <li>- Significant adjustments based on unobservable inputs are made to otherwise observable inputs</li> <li>- Observable market inputs are not available.</li> <li>- Reporting entity's assumptions should be adjusted if they become aware that market participants would use different assumptions</li> </ul>
<p>Stocks in S&amp;P 500 Listed futures &amp; options "On-the-run" government &amp; agency bonds</p>	<p>Infrequently traded public corp. bonds Some MBS and ABS Infrequently traded muni bonds</p>	<p>Private-equity investments Residual tranche securities CDO Equity</p>

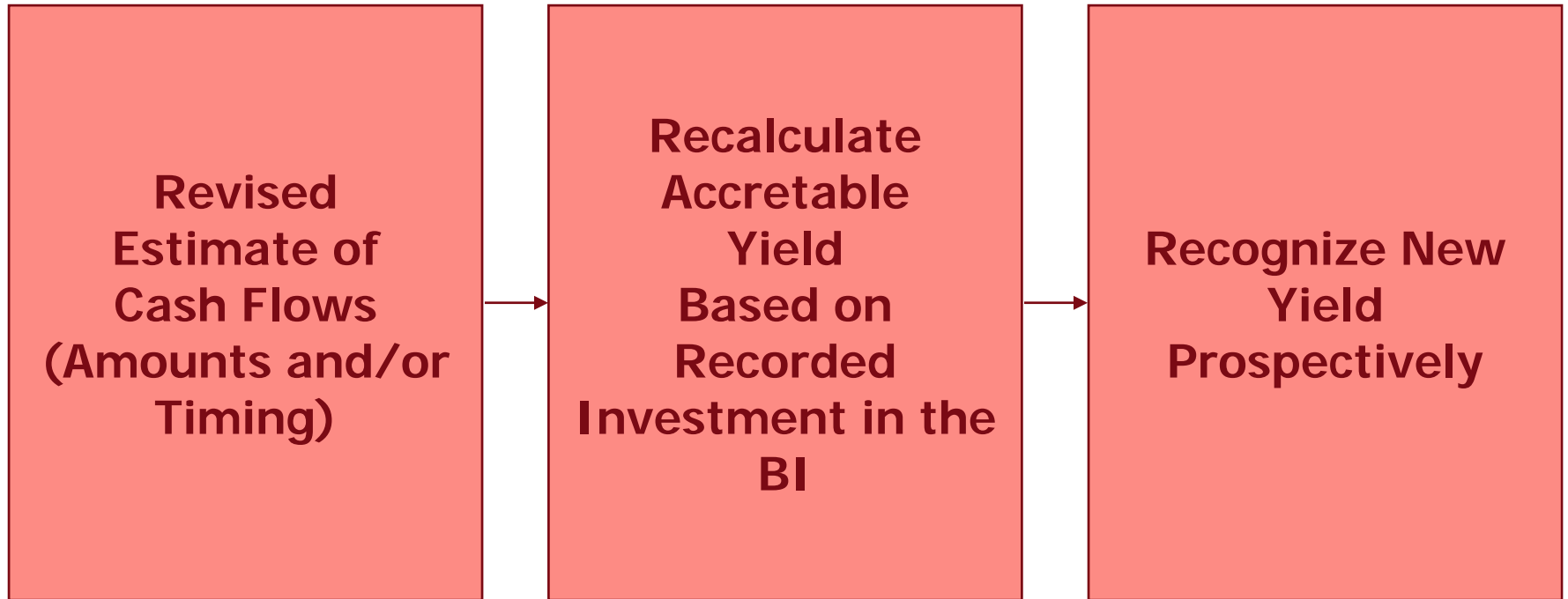
## EITF Issue 99-20: Scope

- Retained or purchased beneficial interests in securitized financial assets that are either:
  - Debt securities under FAS 115; or
  - Required to be accounted for like debt securities under FAS 115 pursuant to paragraph 14 of FAS 140
- Underlying collateral have contractual cash flows (receivables, loans, etc.)
- Exclusion for highly rated securities where the default of principal is remote (AA or above)
- Issue 99-20 applies to the following securities issued by a CDO entity:
  - “Plain vanilla” notes rated less than AA
  - Preference shares

## EITF Issue 99-20: Income Recognition/Impairments – Overview

- Recognize interest income using the effective yield method
- Prospective method for changes in estimated yield
- Periodically update estimates:
  - Yield based on cash flows in excess of carrying amount
  - Consider timing and amount of cash flows
- Impairment recognition based upon adverse changes in discounted cash flows

# EITF Issue 99-20 : Increases in Yield (Favorable Change in Future Cash Flows)



## Assessment of OTT Impairment under EITF Issue 99-20

Step 1 – Assess whether there has been an “adverse change” in estimated cash flows

A. Compare PV of remaining cash flows estimated at initial transaction date (last revised estimate) to

B. PV of latest (current) “best estimate” of cash flows to be received

- “Best estimate” of cash flows: those a market participant uses in determining the FV of the BI
- Discount each estimate using current accretion rate
- Adverse change: when A exceeds B

## Assessment of OTT Impairment under EITF Issue 99-20 (cont)

### Step 2 – Determine if FV of BI is below its current carrying amount (CCA)

- If  $FV \text{ of BI} < CCA$ , and an “adverse change” in future cash flows has occurred: write down the BI to its current FV
  - New cost basis is established
  - Accrete future income based on updated cash flow projections
- If investor cannot reliably estimate future cash flows or places investment on non-accrual status: use cost recovery method