Deloitte.

Financial Reporting Alert 17-1
January 24, 2017

Contents

Variation Margin on Derivatives

Introduction

On January 4, 2017, the International Swaps and Derivatives Association (ISDA) issued a confirmation letter related to its May 27, 2016, accounting committee whitepaper, "Accounting Impact of CCP's Rulebook Changes to Financial Institutions and Corporates May 2016," and the corresponding discussions held with the staff of the SEC's Office of the Chief Accountant. The letter confirms that the staff does not object to the conclusions reached in ISDA's whitepaper.

This *Financial Reporting Alert* provides an overview of the rulebook changes made specifically by the Chicago Mercantile Exchange (CME) and LCH.Clearnet Limited ("LCH" or the "London Clearing House") as well as the accounting impact of these rulebook changes. This publication also outlines a number of unresolved issues that warrant consideration by entities that have derivatives cleared through the CME or LCH.

Overview

Background

The CME and London Clearing House have amended their respective rulebooks[1] to legally characterize variation margin payments — for derivative contracts that are referred to as settled-to-market (STM) — as settlements of the derivative's mark-to-market exposure and not collateral. The impact on derivative contracts cleared through LCH is not as pervasive as that on contracts cleared through the CME since entities that clear through LCH have an option to choose which process governs their derivative contract: either collateralized-to-market (CTM) or STM. The differences between CTM and STM derivative contracts are explained in further detail in ISDA's whitepaper.

[1] The CME's amendments became effective on January 3, 2017.

Accounting Impact of Changes

The paragraphs below outline ISDA's conclusions related to accounting questions that have arisen regarding the change in the legal characterization of the variation margin payments.

Unit of Account

STM derivative contracts, including variation margin and related price alignment amounts, should be considered a single unit of account. Balance sheet presentation may need to be updated to reflect variation margin payments as settlement of the derivative exposure and not collateral against it. As a result, a payer of variation margin has no right to reclaim the cash flow (i.e., no financial asset) and a receiver of variation margin has no obligation to return that cash flow (i.e., no financial liability). Variation margin payments (as well as price alignment interests[2]) are therefore cash flows of the derivative itself, and the derivative contract must be presented net on the balance sheet. Before this change, balance sheet offsetting rules governed whether the receivable/payable related to collateral posted/received could be presented net against the derivative asset/liability on the balance sheet.

Editor's Note

Settlement payments do not terminate the derivative contract, since the future payment obligations and terms of the contract remain intact. Further, although the disclosure requirements for derivatives under ASC 815[3] also continue to apply, variation margin is no longer considered cash collateral and therefore is not considered as such under ASC 815-10-50-4B(b).

Hedge Accounting Upon Transition

Entities that apply hedge accounting for derivative contracts that are cleared through the CME or the London Clearing House[4] do not need to consider the hedging relationship terminated or de-designated upon the modification of the variation margin payment terms and the corresponding change to one unit of account.

ISDA considered whether a change in the accounting for a derivative from two units of account (i.e., the derivative unit of account and the collateral unit of account) to one unit of account would constitute a change in the critical terms of the contract given the introduction of factors that affect the amount and timing of contractual cash flows because of the change in cash flows not previously included in the hedging instrument (derivative unit of account). However, with respect to hedge accounting, what constitutes a critical term is governed by the risk and exposure to the "underlying" regarding the timing or amount of cash flows. The change in legal characterization of variation margin payments as settlements does not affect the value ascribed to the hedge to mitigate the risk. Therefore, ISDA did not believe that this change necessitated a de-designation and re-designation of any related hedging relationships.

Hedge Accounting Going Forward

Regarding the ongoing impact of daily settlements of variation margin, the de-designation and re-designation of existing hedging relationships on a daily basis would not be required solely because the variation margin payments are now being considered settlement payments. Under the STM construct, the variation margin payments are partial settlements of the derivative contract but do not result in the modification or termination of the derivative contract.

[2] Interest accrual paid or received on the posted collateral.

[3] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[4] Before the London Clearing House established the STM construct, all derivatives were considered CTM contracts. Entities that have existing CTM contracts may effectively convert those contracts into STM contracts. Those contracts would be considered modified, as discussed herein.

Questions also arose regarding the application of the shortcut method to assess hedge effectiveness and measure ineffectiveness of these derivative contracts under ASC 815-20-25-102 through 25-106. Since there is no change in the amount and timing of the contractual cash flows of the derivative contract, no new or additional ineffectiveness is introduced to the derivative contract. The single unit of account for the derivative contract, which includes both variation margin and price alignment interest, does not change the derivative's exposure and therefore does not prohibit the application of the shortcut method.

Editor's Note

Entities will still need to ensure that they strictly evaluate any other changes (besides the inclusion of price alignment interest and variation margin payments in the unit of account) under the criteria in ASC 815 when applying the shortcut method.

Additional Issues to Consider

The changes made by the CME and London Clearing House were based on legal opinions obtained regarding the characterization of the payments of variation margin as settlements. Addendums to, amendments of, or re-executions of existing customer agreements are not required as a result of the issuance of the rulebook changes. However, we understand that the scope of these legal opinions may be limited compared with that of the CME and London Clearing House and may not be relied on by any other party (including entities with contracts cleared through the CME and LCH and their auditors).

Entities may thus have an additional burden to ensure that any changes made to their financial statements are based on reasonable and supportable evidence. However, we do not believe that the accounting impact of these rulebook changes would be considered accounting changes under ASC 205.

Subsequent-Event Disclosures

The CME rulebook changes became effective on January 3, 2017. Therefore, when providing their fiscal year 2016 financial statement filings, entities with calendar fiscal year-ends will need to consider the materiality of the potential accounting impact of these changes as well as whether this impact would warrant subsequent-event disclosure. We believe that these disclosures would be within the scope of ASC 855-10-25-3 (nonrecognized subsequent events, or "Type II" subsequent events), since they would be related to conditions that did not exist as of the balance sheet date.

Impact on Realized Versus Unrealized Gains (Losses)

Given the potential changes to the characterization of the variation margin payments as settlements, questions remain regarding whether these daily settlements affect an entity's determination of the timing of realized gains or losses in the income statement.

Impact on Income Taxes

As with the question about income statement classification of realized versus unrealized gains (losses), there are still questions outstanding regarding whether these daily settlements would trigger gains or losses for income tax purposes. We understand that entities may be working with their tax advisers to resolve these issues.

Impact on Fair Value Disclosures

ASC 820-10-50-2(c)(2) requires disclosure of "[p]urchases, sales, issues, and settlements" within the reconciliation from the opening balances to the closing balances (i.e., the "Level 3 rollforward"). Questions remain regarding whether these daily settlements should now be included in this line within the Level 3 rollforward.

Impact on Regulatory Compliance and Statutory Accounting

Given the potential changes to the presentation of these derivative contracts on the balance sheet and the characterization of the variation margin payments as settlements, there are still questions regarding the impact on regulatory capital balances and how potential changes in net presentation could affect compliance with regulatory requirements.

Similarly, the accounting impact of the rulebook changes will need to be considered for statutory accounting and reporting purposes on the basis of the nature and requirements of such statutory filings.

Next Steps

All of these potential issues are being deliberated and will need to be resolved in anticipation of financial statement filings for reporting periods ending after January 3, 2017. Entities should consider the impact that these changes may have in anticipation of such filings.