To the Point

Rule changes for centrally cleared derivatives could affect accounting

Entities that use centrally cleared derivatives should assess the effect of rule changes on their accounting and financial reporting.

What you need to know

- The Chicago Mercantile Exchange (CME) and LCH.Clearnet Limited (LCH) have amended their rulebooks to legally characterize variation margin payments for over-the-counter derivatives they clear as settlements rather than collateral.

- The CME rule changes were effective 3 January 2017 and, therefore, would not affect 2016 financial statements of entities with calendar year ends. LCH changed its rules in 2016, but counterparties can elect whether and when to apply the change.

- In response to questions from the International Swaps and Derivatives Association (ISDA), the SEC staff recently said it does not object to ISDA’s conclusion that variation payments deemed to be legal settlements would be considered as a single unit of account with the derivative for accounting and presentation purposes.

- The SEC staff also said it does not object to ISDA’s conclusion that hedge accounting relationships involving centrally cleared derivatives can continue uninterrupted when the legal characterization of variation margin is changed.

Overview

The Chicago Mercantile Exchange (CME)1 and LCH.Clearnet Limited (LCH) have amended their rulebooks to legally characterize variation margin payments for over-the-counter (OTC) derivatives they clear as settlements of the derivatives’ exposures rather than collateral against the exposures. The changes could have accounting implications for both end users and institutions that serve as clearing members.
The CME rule changes were effective 3 January 2017.\(^2\) As a result, the financial statements of calendar year-end entities will not be affected by these changes until the first quarter of 2017. LCH changed its rules in 2016,\(^3\) but the changes are not mandatory. Instead, entities can elect to change the characterization of their SwapClear contracts\(^4\) from collateralized-to-market to settled-to-market contracts.

Entities should monitor developments at other central clearinghouses to determine whether and when similar rulebook changes may be made.

**Background**

After the financial crisis of 2008, lawmakers and regulators around the world took steps to increase liquidity and reduce counterparty credit risk in the OTC derivatives market. In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act requires many OTC derivatives to be centrally cleared unless the end user qualifies for an exception to this rule. The European Market Infrastructure Regulation also requires central clearing for certain OTC derivatives.

Parties to a centrally cleared OTC derivative exchange daily payments that reflect the daily change in value of the derivative. These payments are commonly referred to as variation margin and serve to protect the parties from a loss if one of them were to default. Historically, variation margin payments have typically been treated as collateral against the derivative position, and the receiving party paid interest to the party that posted the collateral.

For accounting purposes, collateral payments (along with the interest paid or received on them) are generally treated as a separate unit of account from the derivative instrument. As such, entities report a deposit liability (or similar account) for cash collateral received and a receivable (or similar account) for cash collateral paid. Interest on these liabilities and assets is accrued to interest expense or interest income, respectively.

**Key considerations**

The rulebook changes made by the CME and LCH, as supported by legal opinions from their external counsel, would result in the legal characterization of variation margin payments as settlements of the derivative exposure and not collateral against it. The Securities and Exchange Commission (SEC) staff recently said it does not object to ISDA’s conclusion that variation margin legally determined to be a settlement payment and the corresponding derivative instrument would be considered a single unit of account for accounting and presentation purposes.

**How we see it**

To support the characterization of variation margin payments as settlements, entities may need to perform their own legal analysis. This would consider the nature of the contracts an entity is party to and the legal framework that governs them.

It is our understanding that the amounts counterparties exchange will not change as a result of the rulebook amendments. That’s because the variation margin is adjusted daily by what is known as the price alignment amount (PAA), which is identical to the interest that was paid/received on the aggregate collateral balance. However, clearing member banks believe that the legal characterization of variation margin payments as settlements could reduce their regulatory capital requirements.

Including variation margin payments and PAA in the same unit of account as the derivative instrument could have accounting and reporting implications, some of which are discussed below.
Balance sheet presentation and netting
The variation margin paid or received would no longer be accounted separately as an interest-bearing asset or liability. Instead, these payments would be considered in determining the fair value of the centrally cleared derivative, effectively resulting in the derivative having a fair value that approximates zero on a daily basis.

While this may not result in a change in presentation for entities that currently net collateral balances against their derivative instruments in accordance with Accounting Standards Codification (ASC) 210-20, it would be a change for entities that present these balances on a gross basis. Determining whether netting is appropriate under the balance sheet offsetting rules would no longer be required because the rules do not apply to a single unit of account.

Income statement presentation
For derivatives that are not part of a hedging relationship, the rulebook changes could result in the “interest” on variation margin payments (i.e., PAA) being presented in line items such as trading P&L or other income/expense, where an entity currently reports the change in fair value of non-hedging derivatives, instead of interest income or interest expense.

Entities that separately present realized and unrealized gains and losses may need to report all changes in the fair value of affected contracts as realized gains or losses. Considering changes in the fair value of these contracts as realized gains and losses may also have tax consequences.

Hedge accounting
Because many entities use centrally cleared derivatives as hedging instruments, questions were raised about whether including the PAA and variation margin cash flows in the same unit of account as the hedging derivative would require the dedesignation of these hedging relationships. That’s because ASC 815 requires hedging relationships to be discontinued if the derivative instrument is terminated or if an entity wishes to change any of the critical terms of the hedging relationship.

Questions also were raised about whether including the PAA and variation margin cash flows in the same unit of account as the derivative would prevent entities from applying the shortcut method to hedges of interest rate risk using centrally cleared interest rate swaps.

To address these concerns, ISDA included questions about the effect of the rulebook changes on hedge accounting in its submission to the staff of the SEC’s Office of the Chief Accountant. The SEC staff recently indicated that it would not object to the conclusions reached by ISDA that:

- The dedesignation and redesignation of existing hedging relationships would not be required solely because of the rulebook changes made by the CME and LCH.

- The daily settlement of the derivative exposure through daily payment or receipt of variation margin amounts would not require a daily dedesignation and redesignation of hedging relationships.

- Including PAA and variation margin in a single unit of account with the derivative would not prohibit application of the shortcut method.

However, with respect to applying the shortcut method, the SEC staff noted that any changes other than including PAA and variation margin payments as part of the derivative contract would need to be evaluated under the criteria in ASC 815.
Disclosures

The SEC staff also indicated that it does not object to the following conclusions reached by ISDA with respect to disclosures:

- The derivative disclosures requirements in ASC 815 would continue to apply to affected contracts because these contracts remain term instruments, and daily settlement of the derivative exposure does not change or reset the contractual terms of the instrument.

- The requirements in ASC 815-10-50-4B(b) regarding cash collateral disclosures should not be applied to variation margin amounts related to affected contracts.

Given that the fair value of the affected derivative contracts will generally approximate zero, the amounts entities disclose in accordance with the requirements of ASC 820\(^8\) could decline significantly.

Calendar-year entities should also consider whether the expected financial statement effects of the CME rule changes warrant disclosure in their 2016 financial statements.

Endnotes:

1 The CME changes also involve changes to the rules governing the Board of Trade of the City of Chicago (CBOT), New York Mercantile Exchange (NYMEX) and Commodity Exchange (COMEX).

2 Notification to the Commodity Futures Trading Commission (CFTC) of the CME’s self-certifying amendments to its rulebook can be found at www.cmegroup.com/market-regulation/rule-filings/2016/12/16-567R_1.pdf.

3 Notification to the CFTC of the LCH’s self-certifying amendments to its rulebook can be found at www.lch.com/documents/731485/762520/lchclearnet-selfcert-vm+settlement+ph+2+final.pdf/baf159aa-9ff4-4174-993b-5cb7e3a040d.

4 As indicated in LCH’s notification letter to the CFTC, the rulebook changes apply only to house and client contracts of SwapClear Clearing Members. The rule changes do not apply to Futures Commissioners Merchants.

5 ASC 210-20, Balance Sheet – Offsetting.

6 ASC 815, Derivatives and Hedging.


8 ASC 820, Fair Value Measurement.