Defining Issues®

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SEC Staff Clarifies Effect of Rule Changes on Hedge Accounting

The SEC staff recently indicated that rule changes that will be made by certain central clearing parties (CCP) would not require their clearing members or end users to discontinue existing hedge accounting relationships.[1] The SEC staff responded to accounting questions raised by the International Swaps and Derivatives Association (ISDA), which asked for clarification about the accounting for these CCP rule changes.

Key Facts

- The rule changes will treat certain payments as the legal settlement of the outstanding derivative contract exposure instead of the posting of collateral.
- Each CCP will change its own rules. Certain CCP rule changes will result in all payments being considered legal settlement, while others will allow a clearing member to elect the rule changes on an individual contract or portfolio basis.
- Some CCPs have already changed certain of their rules, while others are expected to in the near future.

Key Impacts

- End users and clearing members that clear derivatives through CCPs may need to change how they classify certain payables and receivables related to derivative collateral, and related income and expense amounts in their financial statements.
- End users and clearing members may continue their existing hedge accounting relationships, and thus, will not need to terminate those relationships.

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[1] Chicago Mercantile Exchange, Inc. filed proposed changes to Rule 814 with the Securities and Exchange Commission on January 21, 2015, available at www.sec.gov. LCH.Clearnet filed proposed rule changes with the CFTC on November 18, 2015, available at www.cftc.gov.

Background on Central Clearing

- End users typically enter into a derivative contract to hedge or mitigate a commercial risk. These transactions are generally cleared through a clearing member as an agent to settle the transaction with a CCP due to regulatory requirements.
- Large banks or investment banks who are clearing members may also enter into derivative contracts directly with CCPs.
- The rule changes made by CCPs will affect both end users and clearing members.

After the 2008-09 financial crisis, regulators and governments began requiring certain end users to clear their derivative transactions through a CCP. The Dodd-Frank Wall Street Reform and Consumer Protection Act and the European Market Infrastructure Regulation created these new rules to increase liquidity and reduce counterparty credit risk in the over-the-counter derivative market.

Historically, derivatives cleared through CCPs required clearing members and end users to post cash collateral (i.e., variation margin) based on the daily changes in the fair value of the derivative contract. This reduced counterparty credit risk because the CCP could use the collateral to offset amounts owed if the counterparty defaulted on the derivative contract.

Some CCPs have changed their rules to modify the legal nature of certain variation margin payments so that those payments represent settlement of the derivative contract and not collateral.[2] These changes may affect the balance sheet of an entity with derivatives, and capital amounts for banks that clear the CCPs' transactions.[3]

U.S. GAAP requires a hedging relationship to be discontinued if an entity terminates a derivative hedging instrument or if its critical terms are modified.[4] Some entities were concerned that the rule changes represented either a termination or change in critical terms of the affected derivative contracts. ISDA posed questions about the accounting implications of the rule changes to the staff at the SEC's Office of the Chief Accountant.

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[2] See the Q1 2016 issue of KPMG's *The Bank Statement* for a more detailed discussion of the CCPs' rule changes.

[3] See the Q3 2015 issue of KPMG's *The Bank Statement* for more information about how client clearing of over-the-counter derivatives affects banks' balance sheets.

[4] FASB ASC Sections 815-25-40 and 815-30-40, available at www.fasb.org.

An entity will not need to discontinue its hedge accounting relationships as a result of CCP rule changes.

Continuation of U.S. GAAP Hedge Accounting

The SEC staff indicated that it would not object to the continued application of hedge accounting, including the shortcut method (if otherwise permitted), when the hedging derivative has been affected by the rule changes. The SEC staff cautioned that this view should not be applied by analogy to other situations, and that its conclusion was based on the assumption that no other terms of the derivative contract were changed.

The SEC staff also indicated that it would not object to the view that the daily settlement of derivative contracts created by the CCPs' rule changes do not represent a daily termination of the derivative contracts for purposes of applying hedge accounting. Therefore, the length of the hedge accounting relationship would continue to be the period identified in the hedge documentation. This means that an entity will not need to discontinue and redesignate its hedge accounting relationships on a daily basis, which would have resulted in recognizing additional ineffectiveness.

Other Implications for U.S. GAAP Accounting

The SEC staff indicated that it would not object to entities presenting derivatives affected by the rule changes as a single unit of account on the balance sheet. This is a change from current presentation in which the derivative and related collateral are separately recognized on the balance sheet. The SEC staff noted that its conclusion was influenced by reasoned legal analysis provided by ISDA that payments represent the legal settlement of the outstanding derivative contract exposure instead of the posting of collateral.

An entity will also need to consider other accounting implications of the rule changes related to collateral payments that now represent settlement payments.

Before Rule Changes	After Rule Changes	What Does This Mean?
Balance Sheet		
An entity accounts for variation margin paid or received as interest-earning receivables or payables separate from the derivative asset or liability	Payments will be applied to the derivative contract; an entity will no longer recognize separate receivables and payables related to market exposure	An entity will no longer need to determine whether balance sheet offsetting is appropriate for receivables and payables associated with payments of variation margin[5]

[5] FASB ASC Subtopic 210-20, Balance Sheet—Offsetting, available at www.fasb.org.

Before Rule Changes	After Rule Changes	What Does This Mean?
Income Statement		
An entity recognizes interest income or expense related to variation margin amounts receivable or payable	There will be no separate recognition of interest income or expense related to variation margin amounts, as it will be incorporated into the valuation of derivative contracts	Certain entities will recognize these amounts as part of trading gains and losses if the derivative is not designated as a hedging instrument or is designated in a fair value hedging relationship
For derivatives that are not designated as hedging instruments, an entity recognizes unrealized gains or losses daily based on changes in fair value	Daily settlement of the derivatives will result in an entity recognizing realized gains and losses on a daily basis	The changes will affect the income statement amounts for an entity that separately presents realized and unrealized gains or losses

An entity that presents collateral payments netted with the associated derivative will need to make only a few changes to its balance sheet.

Disclosures. Because U.S. GAAP offsetting guidance may no longer apply for payments that represent settlement, the rule changes will affect the required disclosures related to offsetting collateral receivables or payables with the associated derivative balance.[6]

Entities will still be subject to the disclosures required under the derivatives and hedging guidance, but the rule changes will affect how entities apply those disclosure requirements. The required disclosures include quantitative information about the location and amounts in the financial statements of the fair value of derivatives and their related income statement line item. Cash collateral disclosures required by the derivatives and hedging guidance will no longer apply for payments that represent settlement rather than collateral.[7]

Next Steps

Some CCPs have already changed their rules, while others will soon do so. Because the rule changes will be different among CCPs, an entity should assess how its derivative contracts may be affected and determine whether it needs to change its accounting and disclosures.

[6] FASB ASC paragraphs 210-20-50-1 to 50-6, available at www.fasb.org.

[7] FASB ASC Topic 815, Derivatives and Hedging, available at www.fasb.org.

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