

**ISDA Accounting Committee White Paper:
Consideration of Accounting Analysis for CCP Recovery and
Continuity Tools**

October 2015

ISDA believes that effective central counterparty (CCP) recovery and continuity mechanisms are critical to the efficient operation and sustainability of the financial markets, and in preventing contagion risk from the default of one or more clearing members.

ISDA members welcome the work that is being carried out at the regulatory and governmental level on these topics. It is our understanding that there are currently no specific provisions in CCP rule books incorporating partial tear-ups. As such, the aim of this paper is to identify and comment on the broad principles that should be considered from an accounting perspective, rather than give a definitive opinion on specific fact patterns.

ISDA members have been discussing the requisite accounting criteria to net cleared transactions with the industry, including CCPs, clearing members, financial institutions and accounting firms. There is a broad consensus on the need for CCP rule books to incorporate tools that respect US GAAP and IFRS accounting standards, such as the partial tear-up of contracts to re-establish a matched book in the case of market disruptions.

ISDA believes incorporating tools that meet the accounting standards for the netting of cleared transactions is fundamental, as the inability to net cleared derivatives transactions and therefore report them in financial statements on a gross basis would render clearing uneconomical. As such, the discussion of the accounting considerations in this paper is fundamental for the implementation of the clearing provisions enacted in the European Market Infrastructure Regulation and Dodd-Frank Act.

A. Overview and Scope

Central counterparties (CCPs) are required to develop recovery plans in order to avert a threat to their viability and ensure they can maintain continuity of critical services in times of market stress. One threat to CCP viability is the default of one or more clearing member(s) (CM(s)). In January 2015, ISDA published a white paper entitled [CCP Default Management, Recovery and Continuity](#), in which ISDA proposed a recovery framework to address this specific threat. Among other things, ISDA contemplated a situation where a CCP may be able to auction most of the hedged portfolio of the defaulting CM(s), but the remainder of the portfolio (the "Remainder") attracts no bids and therefore creates open exposure for the CCP.

To enable the CCP to extinguish this exposure, ISDA proposed that the CCP adopts rules permitting partial tear-up¹. ISDA acknowledged that different CCPs have different legal requirements and businesses, and therefore would need to tailor partial tear-up to meet their particular circumstances. However, ISDA believes that a CCP should ensure its partial tear-up design would not:

- Frustrate requisite accounting criteria for determining the counterparty that direct clearing participants (CPs) are deemed to face on centrally cleared derivatives; and
- Reduce the amount of netting applied for accounting purposes.

This paper aims to provide more detail on some factors that a CCP should consider in structuring a partial tear-up regime so as to not to contravene rules on offsetting under the applicable accounting standards. This paper is limited in scope to accounting considerations under US Generally Accepted Accounting Principles (US GAAP) and International Financial Reporting Standards (IFRS). It does not address the commercial viability of partial tear-up, or whether partial tear-up meets the risk management objectives of CCPs or applicable supervisors and regulators².

B. Background

B1) What is partial tear-up?

ISDA's January 2015 paper on CCP recovery contemplated a situation where a CCP may be able to auction most of the hedged portfolio of the defaulting CM(s), but the Remainder attracts no bids and therefore creates open exposure for the CCP.

¹ ISDA's White Papers [CCP Loss Allocation at the End of the Waterfall](#) (August 2013) and [CCP Default Management, Recovery and Continuity: A Proposed Recovery Framework](#) (January 2015)

² Nothing in this paper constitutes legal, accounting or financial advice or advice regarding specific partial tear-up structures. ISDA assumes no responsibility for any use to which the guidance provided in the accounting paper may be put. Each party following the accounting paper must satisfy itself that its implementation is appropriate for a transaction, and has been properly applied in the context of the transaction to reflect the commercial intention of the participants. All ISDA members are encouraged to consult with their own accounting firms and legal counsel.

For the avoidance of doubt, the Remainder may consist of:

- The proprietary positions of the defaulting CM;
- Any customer or client positions of the defaulting CM that the CCP has not successfully ported; or
- A combination of the two.

Partial tear-up would permit a CCP to re-establish a matched book with respect to the Remainder. A CCP may structure partial tear-up in a number of ways. Whatever the structure, the CCP's methodology for partial tear-up should be transparent, written in its rule book and available to all potentially affected parties.

This paper has considered the following partial tear-up structures. The structures examined are not meant to be exhaustive.

- A. The CCP terminates on a pro rata basis only the positions of both direct and indirect CPs necessary to offset the Remainder.
- B. The CCP terminates all open contracts in a particular service (i.e., all swaption contracts denominated in a particular currency, or all interest rate swaps contracts denominated in a particular currency with a maturity greater than a specified date³).

All structures assume that the CCP terminates identified positions at the last available price for that contract (i.e., at "fair-value"), and that partial tear-up is not a means of loss allocation but solely aimed at enabling the CCP to re-establish a matched book.

C. Accounting Considerations

In assessing whether its partial tear-up regime could be construed to contravene the accounting assumptions noted on page 2, a CCP should consider the factors set out below.

C1) Determination of the CCP as principal counterparty to direct clearing participants' proprietary trades

In most cases, direct CPs currently consider the CCP to be their principal counterparty for proprietary derivatives positions when determining which entity they have exposure to and which entity their derivatives assets or liabilities should be reflected against for accounting purposes. Such an assessment is crucial to the ability of a CP to net cleared derivatives exposures for financial statement purposes, as netting is generally only applicable to transactions with the same counterparty (in the case of cleared derivatives, the CCP).

³ The specified date would be determined with reference to the shortest maturity of any Remainder trade of the defaulted CM within that product/currency, in order to adequately capture trades necessary to return the CCP to a matched book.

In determining this, there are two key factors:

- Legal form: whether a CCP is legally the principal counterparty to a direct CP. This would necessitate a legal review of whether the transaction between the CP and bilateral counterparty has been legally novated to the CCP, among other things; and
- Substance: whether the operation of the CCP's default management process could be construed to undermine any legal conclusion that the CCP is the principal counterparty to the proprietary derivatives transactions entered into by the direct CP.

This paper relies on previous legal work that CPs and infrastructures have conducted in certain jurisdictions on whether a CCP is legally a principal counterparty of the direct CP upon novation, subject to certain conditions⁴.

Assuming that prior legal conclusions remain valid, further consideration should be given to each CCP's default management process (DMP) to assess whether the triggering of this process could undermine the determination that the CCP is principal counterparty. An assessment should be made of whether the original proprietary bilateral trades submitted by a direct CP for clearing, and now deemed to be between CCP and the direct CP, are maintained by the CCP in the event of a default of the direct CP's original bilateral counterparty, thereby exposing the CCP to the risks of those trades. The alternative is that they are returned/re-novated to the original CP(s) that were party to those trades. The CCP's DMP will determine this assessment, as it will indicate whether the clearing process results in loss mutualisation and transformation of the direct CP's credit risk, or whether the CP's risk position effectively remains a bilateral counterparty exposure.

C2) Continued ability of a CP to apply netting of derivatives assets, liabilities and related cash collateral for financial reporting and regulatory capital purposes

Once it has been determined that the direct CP's principal counterparty is the CCP, the netting requirements of US GAAP and IFRS must be considered. This paper does not offer a view on whether netting is possible for each CCP.

⁴ Such previous legal work was also conducted in certain jurisdictions to determine whether a legally enforceable right of setoff exists as between the CCP and the CM. This paper assumes that the CCP will implement partial tear-up so as to leave existing legal conclusions undisturbed, or that new legal opinions would be commissioned that reach substantially the same or similar conclusions.

In addition, each CP will have to determine, based on the prevailing CCP rule books and legal frameworks, whether it is able to apply netting for accounting and regulatory reporting purposes on a CCP-by-CCP basis. This paper does not give a view on whether a CM would be able to net for each CCP. Rather, it limits itself to considering whether the introduction of certain partial tear-up structures by a CCP would likely threaten or negate any positive netting conclusion that a CP has already reached under the current CCP rulebook or legal framework.

Rather, it assumes a CP has positively determined under the CCP's current rule book or legal framework that netting can be applied, and considers whether the introduction of a partial tear-up regime would threaten or negate that conclusion.

An enforceable legal right of offset is a prerequisite in order to apply netting under both US GAAP and IFRS. For the purposes of this paper, it is assumed that any legal right of offset currently in force between a CP and CCP is not negated by any change to rule books required to implement the recovery tools and that, where required, legal opinions will be updated to address those rule-book changes. Consideration has therefore been given to the factors other than legal right of offset, as detailed in D2) below.

C3) Assessment of direct CPs role in clearing trades for indirect CPs as principal or agent for accounting purposes

In some instances – predominantly under US GAAP – direct CPs may have determined that, for accounting purposes, they act as a clearing agent for indirect CP trades rather than as principal, meaning the direct CP does not reflect back-to-back derivatives trades between the indirect CP and the CCP on its balance sheet. Partial tear-up regimes should be considered in the context of whether they negate an agency conclusion, and should be designed and implemented wherever possible so as not to alter this conclusion.

C4) Relevant accounting literature

Refer to Appendix I for relevant accounting literature.

D. Application of Accounting Considerations to Contemplated Partial Tear-up Regimes

D1) CCP as principal

Regardless of the specific methodology selected by a CCP for the identification of trades to be terminated as part of a partial tear-up, in order for the CP to continue to view the CCP as its counterparty for accounting purposes, it is essential that the CP's exposure after clearing continues to be different to the CP's exposure prior to the clearing of the original bilateral trade.

CCPs may not intend to deliberately refer back to the original bilateral transactions (the "Original Bilateral Transactions") when identifying trades for tear-up. In addition, it may be highly unlikely (especially for high-volume, standard-term products) that a CCP would identify a subset of trades for partial tear-up that would be identical to the specific, individual bilateral derivatives positions that a non-defaulting counterparty originally entered into with the defaulting CM. The assessment should therefore focus on whether the method for identifying the set of trades for pro-rata tear-up is broad enough to ensure the probability of identifying only the original bilateral transactions is low.

For standard-term products, a methodology under which the CCP terminates on a pro-rata basis the minimum number of positions to offset the Remainder portfolio (scenario A, as detailed on page 3) would therefore be likely to adequately ensure that the probability of identifying only the original bilateral transactions is low.

For non-standard-term products, the more bespoke nature of individual trades (in terms of rate, tenor, currency, for example) results in a lower number of trades for each trade type across the total volume of all trades. It is therefore more likely that the only CP to hold an identical offsetting risk position (i.e., same rate, tenor, currency) is the CP that originally faced the defaulting CM on a bilateral trade. As such, a CCP may wish to identify a broader set of transactions for partial tear-up (such as all interest rate swaps in a particular currency) to avoid negating the conclusion that the CCP is the principal counterparty of the CM. A tear-up methodology that is based on tearing up all open contracts within a defined subset (scenario B, as detailed on page 4) is therefore expected to be necessary for non-standard-term products.

In assessing this, consideration should also be given to the DMP more broadly, and whether partial tear-up is only to be utilised as a last resort at the end of an established DMP. To the extent the likelihood of a partial tear-up process is remote but is nevertheless included in the rule book/DMP framework in order to cover tail-risk events, a method of identifying trades for tear-up that results in a low, but greater than negligible, chance of identifying a subset of trades for tear-up that would be identical to the original bilateral transactions may not negate the conclusion that the CCP is the CP's principal counterparty.

D2) Ability to apply netting

To the extent that a CCP states explicitly in its rule book that partial tear-up would occur at the prevailing market price (i.e., the most recent settlement price), then partial tear-up should not negate the ability to apply netting.

US GAAP restricts netting to instances where the two parties owe each other 'determinable amounts'. Where the value at which trades identified for tear-up are terminated is based on the most recent margin call/settlement price valuation, partial tear-up should not negate this criterion.

IFRS guidance for offsetting does not include the same 'determinable amount' criteria. It is still possible to assert that the value of derivatives outstanding between a CP and the CCP are expected to be offset in the ordinary course of business or in an insolvency scenario while the value at which contracts are terminated is at the prevailing market price net of variation margin.

D3) Assessment of direct CPs role in clearing trades for indirect participants, as principal or agent for accounting purposes

Under US GAAP, direct CPs have concluded that, for many CCPs, their role in clearing client trades (i.e., trades of indirect CPs) is that of agent, either in legal terms or in substance. As a result, the direct CP is not principal in back-to-back trades between the indirect CP (client) and the CCP.

A significant factor in this analysis is that the direct CP does not have two-way credit risk to both the CCP and its customer. Typically, the direct CP does not have credit risk to the CCP in respect of the indirect CPs trades, since it does not guarantee the CCP's performance. The direct CP, acting as clearing agent for the indirect CP's trades, has credit risk exposure to the indirect CP, which is – at least in part – mitigated by the receipt of collateral. Assuming partial tear-up is not a means of loss allocation, but is solely a tool designed to allow the CCP to re-establish a matched book, the US GAAP treatment applied by direct CPs to client-clearing arrangements should not be affected.

For jurisdictions where the legal framework for client clearing results in back-to-back principal trades between the CCP, the CM and the end client, a further consideration is how a CCP's tear-up methodology will apply to the trade between the CM and its client. To the extent that the CCP's recovery and resolution framework ensures enforceability of the tear-up process through to client trades, without the CM exercising discretion on whether or how to affect the trade it has with the client, the accounting representation by the CM of its role as agent should not be affected. Ultimately, if the agency accounting representation is to be upheld, the CCP's tear-up process should be designed to ensure that any action on the trade between the CCP and CM will be mirrored in the trade between CM and client.

E. Conclusions

This paper aims to identify the potential accounting consequences of different CCP partial tear-up structures under US GAAP and IFRS.

As developed in this paper, a preliminary examination indicates it is possible for a CCP to design and implement a partial tear-up regime that does not frustrate the accounting considerations outlined in section A of this paper.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 850 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Appendix I: Relevant Accounting Literature

US GAAP: ASC 210-20-45 Offsetting (Formerly FIN 39)

Balance Sheet—Netting

45-1 Subtopic 210-20: establishes the criteria for offsetting amounts in the balance sheet.

45-2 None of the provisions in this Subtopic support netting a hedging derivative's asset (or liability) position against the hedged liability (or asset) position in the balance sheet.

45-3 The following guidance addresses offsetting certain amounts related to derivative instruments. For purposes of this guidance, derivative instruments include those that meet the definition of a derivative instrument but are not included in the scope of this Subtopic.

45-4 Unless the conditions in paragraph 210-20-45-1 are met, the fair value of derivative instruments in a loss position shall not be offset against the fair value of derivative instruments in a gain position. Similarly, amounts recognised as accrued receivables shall not be offset against amounts recognised as accrued payables unless a right of setoff exists.

45-5 Without regard to the condition in paragraph 210-20-45-1(c), a reporting entity may offset fair value amounts recognised for derivative instruments and fair value amounts recognised for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from derivative instrument(s) recognised at fair value executed with the same counterparty under a master netting arrangement. Solely as it relates to the right to reclaim cash collateral or the obligation to return cash collateral, fair value amounts include amounts that approximate fair value. The preceding sentence shall not be analogised to for any other asset or liability. The fair value recognised for some contracts may include an accrual component for the periodic unconditional receivables and payables that result from the contract; the accrual component included therein may also be offset for contracts executed with the same counterparty under a master netting arrangement. A master netting arrangement exists if the reporting entity has multiple contracts, whether for the same type of derivative instrument or for different types of derivative instruments, with a single counterparty that are subject to a contractual agreement that provides for the net settlement of all contracts through a single payment in a single currency in the event of default on or termination of any one contract.

45-6 A reporting entity shall make an accounting policy decision to offset fair value amounts pursuant to the preceding paragraph. The reporting entity's choice to offset or not must be applied consistently. A reporting entity shall not offset fair value amounts recognised for derivative instruments without offsetting fair value amounts recognised for the right to reclaim cash collateral or the obligation to return cash collateral.

A reporting entity that makes an accounting policy decision to offset fair value amounts recognised for derivative instruments pursuant to the preceding paragraph but determines that the amount recognised for the right to reclaim cash collateral or the obligation to return cash collateral is not a fair value amount shall continue to offset the derivative instruments.

45-7 A reporting entity that has made an accounting policy decision to offset fair value amounts is not permitted to offset amounts recognised for the right to reclaim cash collateral or the obligation to return cash collateral against net derivative instrument positions if those amounts either:

- a. Were not fair value amounts
- b. Arose from instruments in a master netting arrangement that are not eligible to be offset.

IFRS: IAS 32 Financial Instruments: Presentation

42 A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

- (a) Currently has a legally enforceable right to set off the recognised amounts; and
- (b) Intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.