International Swaps and Derivatives Association
Accounting Policy Committee
Accounting Impact of CCPs' Rulebook Changes to Financial Institutions and Corporates
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Introduction:

The purpose of this whitepaper is to consider the potential accounting impacts of certain announcements and rule changes by central clearing parties ("CCP(s)"). Each of the Chicago Mercantile Exchange ("CME") and LCH.Clearnet Limited ("LCH") (collectively, the CCPs)[1] have or will make certain rulebook amendments which will result in certain contracts being characterized as settled-to-market ("STM"). Both financial institutions[2] and certain end users[3] that utilize centrally cleared derivatives as designated accounting hedges could be significantly impacted by these rule changes.

Background:

In response to the financial crisis of 2008, governments and global regulators passed various reforms meant to increase liquidity and reduce counterparty credit risk existent in the bilateral/over-the-counter ("OTC") derivatives market. In the U.S., the Dodd-Frank Wall Street Reform and Consumer Protection Act Title VII ("Dodd-Frank") significantly changed regulations for derivatives, including requiring certain derivative types (most notably swaps) to be centrally cleared to the extent the end user did not meet an exception. In addition, in Europe, the European Market Infrastructure Regulation ("EMIR") also requires central clearing for certain OTC derivatives.

<u>*Collateralized-to-Market/Settled-to-Market*</u>

It is generally understood that there is a difference between derivatives that are structured and documented as "collateralized-to-market" ("CTM") and those that are structured and documented as "settled-to-market" STM[4]. Neither CTM nor STM are terms that have been given specific legal meaning in either the U.S. or in any European jurisdiction and are simply commercial terms that are used to differentiate between two types of derivative contracts that use different means to achieve a consistent purpose of mitigating or settling counterparty credit risk arising from movements in the mark to market value ("MTM"[5]) of a derivative in favor of one party or the other which would otherwise be an unmitigated exposure to the owing counterparty.

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[1] While this whitepaper addresses certain accounting issues concerning the rulebook changes of CME and LCH, the conclusions herein are intended to apply to other clearing houses that implement similar rulebook changes.

[2] Financial institutions that are subject to mandatory clearing include large commercial banks and regional banks (community banks with total consolidated assets below $10 billion are generally exempt from clearing under the Dodd-Frank Act), hedge funds and other asset managers, and life insurance companies

[3] Such end users primarily comprise non-financial corporates and finance / treasury affiliates thereof that have not elected or do not qualify for the end-user exception under Dodd-Frank and non-financial corporates that will be subject to mandatory clearing under the European Markets Infrastructure Regulation at a future date

[4] CTM and STM are terms commonly used by LCH. CME generally refers to these concepts simply as collateral or settlement. For simplicity, this paper uses CTM and STM to refer to these concepts.

[5] References to MTM in this paper are based on valuations calculated by the relevant CCP.

While the purposes of the arrangements are similar, the nature of the rights and obligations between the parties differ between CTM and STM arrangements. In a CTM model, upon close-out[6] of a derivative contract, the non-defaulting counterparty may set-off (where the legal rights and obligations support this right of set-off) collateral it has received from the defaulting party against amounts it owes to that party in respect of the derivative's MTM value. In a STM model, there would be no set-off in relation to amounts of variation margin cash collateral, because no such collateral is provided in connection with such contract. Rather, upon closeout of a STM contract, the determining party would simply ascertain the unsettled MTM of the derivative contracts at the relevant point in time with the resulting amount being payable by one party to the other.

However, the economic cash flows exchanged between parties to CTM and STM derivatives are identical and include both an initial margin and variation margin amount[7]. Initial margin is typically posted at the beginning of the trade/contract based on established collateral amounts determined by the CCP and remains posted with the CCP until the trade/contract matures or is terminated. Variation margin is required to be posted daily through the life of the contract and is based on changes in the MTM of the derivative contract. The variation margin is adjusted daily by an amount called price alignment interest ("PAI") in order to mitigate the basis risk[8] between uncleared and cleared swaps. PAI, which is also referred to as price alignment amount ("PAA") for STM contracts by the LCH and will be referred to as price alignment ("PA") by the CME once its 2016 Rulebook Change becomes effective, is calculated identically and serves the same purpose, namely to address this basis risk.[9]

A CTM derivative, whether cleared or not, generally requires the out-of-the-money party to periodically transfer to the in-the-money party collateral with value equal to the cumulative MTM of the derivative contract. We understand that the majority of entities have generally

[6] Close-out permits a non-defaulting counterparty to unilaterally terminate a derivative contract under certain conditions (e.g., a default by the other counterparty or a contractually agreed-to credit event).

[7] These terms are commonly used in the CTM context, but refer generically to amounts paid or exchanged between the counterparties. Within the STM context, market participants may refer to variation margin simply as payments. For simplicity, this paper uses the term variation margin to describe these payments made, regardless of whether in CTM or STM, without intending any specific meaning to the term margin.

[8] The Credit Support Annex of a collateralized non-cleared OTC derivative generally requires the party that receives collateral (generally cash) to compensate the party that posted the collateral. The compensation was generally in the form of interest and is economically consistent with the calculation of PAI. Had PAI not been included in the calculation of variation margin, there would be a difference in the contractual cash flows for a derivative contract that is cleared versus collateralized, but not cleared.

[9] In the early stages of clearing, as the market was in its infancy, it was determined that the success of clearing was dependent on ensuring that the design of any cleared OTC contracts enable such contracts to function as economically equivalent products to the related uncleared OTC contracts – both for hedging and risk management purposes. In the uncleared OTC space, since both the payee and payor of variation margin view the payment as collateral received and held by the payee as security against the payor's default, it has been traditional for payees to compute and adjust for interest on such amounts throughout the life of the contract. If the cleared contracts were to economically track the OTC contracts, a similar adjustment needed to be incorporated into the daily variation payment calculated by CCPs. This adjustment is referred to as price alignment interest or PAI. Although CCPs referred to this amount as PAI, we believe that the primary purpose of this amount was to ensure equivalence in the cash flows of the two types of derivatives, rather than to contribute to the ultimate characterization of the payment.

historically accounted for variation margin payments on swaps as collateral (i.e., the party posting collateral would record a receivable for the eventual return of the collateral). PAI was recorded by some entities as interest income on such receivable (or interest expense on such payable) and by others within the realized trading gains and losses caption, which would be consistent with the presentation of the change in fair value of the derivative instrument itself.

Like cleared CTM derivatives, cleared STM derivatives are generally structured so that on a daily basis the current MTM of the derivative is determined by the CCP. Upon this determination, the gain accruing to one of the parties as a result of the movement in the MTM of the derivative since the previous periodic calculation becomes due and payable to the applicable party. Unlike CTM derivatives, this amount is settled by the payment of variation margin to the party in a gain position pursuant to the CCP's terms and procedures. The MTM of the derivative is reset to zero, based on the CCP's valuation methodology, to reflect the periodic settlement in accordance with the contractual terms. From a legal perspective, the payment or receipt of variation margin "VM" and PA/PAA in connection with an STM contract would not be characterized as pledged collateral that secures the obligations between the clearing member ("CM") and CCP. In fact, if an STM derivative were to be novated from one CM to another CM, any amounts paid/received for variation margin and PA/PAA prior to novation would not be owed back to the original party who paid it to the recipient and would not be clawed back as collateral.

The overall cash flows under a CTM and STM arrangement for a derivative contract with the same terms would be exactly the same in amount and timing. The prominent difference is that the CTM contract would have a cumulative MTM with an equal amount of collateral posted by the counterparty holding the loss position, while the STM contract would reflect a MTM of zero and no collateral posted.

For an STM contract, the daily payment or receipt of variation margin settles the outstanding MTM exposure, as per the CCP's valuation, but does not result in any other change or reset of the contractual terms of the instrument. The derivative continues to be a term instrument with the underlying contractual terms remaining the same. In the example of an interest rate swap under which the party pays (or receives) a fixed interest rate and receives (or pays) a floating price interest rate index, the daily payment of variation margin does not result in any amendment or reset of the fixed rate to prevailing market rate, and the fixed rate set at inception of the trade will continue to be the applicable rate throughout the term of the instrument.

From an accounting perspective, we believe the determination of the appropriate unit of account for STM contracts should primarily be based on the legal analysis, especially in the absence of specific accounting guidance on this matter. As described in more detail below, the CCPs obtained (or will obtain) legal opinions that support the characterization of variation margin payments and related price alignment amounts as settlement of the derivative's exposure. Accordingly, we expect entities to respect this legal characterization and account for an STM contract as one unit of account.

The legal determination of variation margin as settlement of the exposure results in the payer of variation margin having no right to reclaim that cash flow back in the future (i.e. a financial asset), and the receiver of variation margin having no obligation to return that cash flow in the future (i.e. a financial liability). As such, it would not be appropriate for payments and receipts of variation margin to give rise to the recognition of financial assets and financial liabilities related to those flows as separate units of account. The cash flows serve to settle and reduce the recognized asset or liability arising from the derivatives' MTM, and not to result in additional financial assets or liabilities being recognized.

Chicago Mercantile Exchange

On December 31, 2014, the CME submitted to the Commodity Futures Trading Commission ("CFTC") proposed changes to Rule 814 of the CME Rulebook addressing the treatment of variation margin on trades cleared through the CME ("2015 Rulebook Change")[10]. The submission was made on a self-certification basis and the changes to Rule 814 became effective on January 16, 2015.[11]

The CME's intent and purpose of the changes to Rule 814 was to clarify that the payment of variation margin represents[12] the daily settlement of the outstanding MTM of the derivative contract, rather than posted collateral. Under Rule 814, as amended by the 2015 Rulebook Change, each payment of variation margin for commodities[13] traded on the CME was intended to represent settlement and was to be final on the earlier of the time when an irrevocable commitment to pay has been provided or the time when the clearing house's accounts are debited or credited with the settlement payment. In response to this rule change, certain clearing firms had discussions with external counsel with the goal of obtaining a legal opinion that would support the characterization of the payment of variation margin between CMs and the CME as settlement (i.e., as opposed to collateral payments). These discussions indicated that further clarification of CME rules would be necessary in order to facilitate the issuance of such an opinion.

During 2015, FIA Global, a global trade association, formally requested that CME obtain a legal opinion with respect to the characterization of the payment of variation margin between CMs and the CME as settlement (i.e., as opposed to collateral payments). In working with external counsel and the global trade organization, additional clarifying language was suggested for incorporation in the Rulebook. We understand that in 2016 the CME intends to file notice of

[10] CME filed the proposed changes to Rule 814 with the Securities and Exchange Commission ("SEC") on January 21, 2015, and they became effective upon such filing. The SEC solicited public comments during a 21-day comment period. At any time during the 60 days following the filing, the SEC could have temporarily suspended effectiveness of the rule changes, but it did not elect to do so.

[11] The Commodity Exchange Act (as amended, the "CEA") provides that a derivative clearing organization such as the CME may elect to approve and implement any new rule or rule amendment by providing the CFTC with a written certification that the new rule or rule amendment complies with the Commodities Exchange Act. The CFTC may stay the certification of the new rule or rule amendment for up to ninety days. The CFTC did not stay the certification of the CME's rule changes or request that the CME amend or supplement the rule.

[12] Certain CME officials have stated that this was simply a clarification of existing treatment; market participants, however, had generally accounted for variation margin on CME-cleared trades as collateral.

[13] CME Rule 814 specifically uses the term "Commodity or Commodities". The CME Rulebook defines a Commodity as "any product approved and designated by the Board for trading or clearing pursuant to the rules of the Exchange." Generally, this includes Base Guaranty Fund Products, Credit Default Swap Products, and Interest Rate Swap Products.

such additional rulebook changes ("2016 Rulebook Change") with the CFTC[14] which will further clarify the nature of payment of variation margin as settlement.

Pursuant to the 2016 Rulebook Change, the terms "variation margin" and "price alignment interest" will be substituted by the terms "settlement variation payment" and "price alignment,"[15] respectively. The CME has obtained a draft legal opinion from external counsel, based on this additional 2016 Rulebook Change, supporting the payment of variation margin and PA between CMs and the CME as settlement. We understand, as of the date of this whitepaper, that the 2016 Rulebook Changes have not been filed or certified and the draft opinion has not been issued as final. If and when the 2016 Rulebook Changes are filed and accepted by the CFTC, the transition to settlement would be triggered at such time.

We understand that the treatment of variation margin as either collateral or settlement for the contracts between an end user and its respective CM could mirror the treatment for the contracts between such CM and the CME based on the contractual relationship between the end user and the CM established in the customer agreement between the two parties. We understand that the current expectation is that adoption of the 2016 Rulebook Change and issuance of the referenced legal opinion is not expected to require addendums to, amendments of, or re-execution of all customer agreements in order to align the characterization of variation margin payments and PA exchanged by the end user/CM and the CM/CCP. Accordingly, end users could be significantly impacted by the hedge accounting issues discussed below.

LCH Clearnet

In November 2015, LCH proposed rule changes that would allow its SwapClear CMs to elect to change their outstanding and new SwapClear Contracts[16] from SwapClear CTM Contract to the new SwapClear STM Contract.[17] The change from a CTM to STM contract results in the variation margin on such contracts being considered as settlement of any existing MTM on the respective derivative instead of as collateral. Under the changes, SwapClear STM Contracts would be structured as follows:

(1) The outstanding MTM of either LCH or the CM that arises from such SwapClear STM Contract would be fully and finally settled on a daily basis; and
(2) Under the changes, the SwapClear STM Contracts would be structured such that the MTM of the contract is reset daily to zero on the basis of the variation margin amount calculated by the CCP.

[14] CME Inc. is no longer registered with the SEC and therefore, unlike the 2015 Rulebook Change, will file notice with the CFTC only.

[15] Price alignment interest, to be re-termed 'price alignment' is an amount calculated in accordance with CME's operational procedures. Under the proposed Rule 814, price alignment is then considered a component of the "outstanding exposure" amount in Rule 814.

[16] SwapClear products consist of interest rate swap products cleared by LCH.Clearnet. A complete listing of SwapClear products can be found at www.swapclear.com/what/.

[17] Note that in comparison to the CME's single rulebook (which is subject to the above-referenced change), LCH introduced an additional rulebook (i.e., STM) and will continue to also maintain its existing CTM rulebook.

We also note that for SwapClear STM contracts, the calculation of PAA is governed by the terms of a settled to market swap under Regulation 57A. As explained above, PAA is the economic equivalent of PAI. Like PAI, PAA is based on the cumulative variation margin payments and is economically equivalent to the interest amount owed to the counterparty transferring the variation margin.

The rule changes (Phase 1) currently apply to CMs of LCH.Clearnet Limited who elect to convert all of their house trades (i.e., derivatives to which the CM is a principal); therefore Phase 1 does not affect end users. Under Phase 2 (expected to be in place in calendar Q3 2016), CMs would have the option to partially convert a portfolio of house trades on a trade-by-trade basis (rather than their entire population of house trades cleared on LCH). Phase 2 would also allow partial conversion to STM, for a portfolio of CM client transactions, which would impact many more end users. We understand for Phase 2, end users would need to elect to transition from CTM to STM.

STM Contracts may come into existence at trade inception or following:

(1) The acceptance by LCH of a conversion request of a CM for its CTM contracts;[18]

(2) The compression[19] of a SwapClear portfolio that contains both STM contracts and CTM contracts; or

(3) A pre-default transfer or post-default transfer (porting[20]).

On conversion, the rulebook change is explicit that there is no termination of the original CTM contract to be replaced by a new STM contract, but rather change to the contractual provision of the existing contract by mutual agreement.[21] LCH also obtained a legal opinion from external counsel dated December 7, 2015 supporting the payment of outstanding MTM under STM contracts as settlement rather than collateral (from a legal form perspective) and provided this opinion to CMs. LCH's counsel has provided this opinion solely for the benefit of LCH and CMs. It analyzes the characterization of variation margin under STM contracts as settlement, and concludes that the relevant provisions of the LCH rulebook supporting such characterization are enforceable, under the laws of England and Wales.

[18] Note that an entity may elect to convert a contract from CTM to STM but may not elect to convert a contract from STM to CTM.

[19] Compression is a process whereby a CCP will net offsetting exposures from separate contracts of a counterparty and only require the transfer of margin related the net MTM of the netted or compressed contracts.

[20] Porting is the process of a CCP transferring the client (end-user) positions from a defaulting clearing member to a non-defaulting clearing member.

[21] See LCH.Clearnet Limited Regulation 57A(n).

Summary of Practice Issues:

Question 1: Would adoption of the proposed CME 2016 Rule Book Change and LCH's STM rulebook change cause a discontinuance of existing hedging relationships?

Conclusion – No, the hedging relationships are not required to be discontinued

Proponents of this view believe that an existing hedge relationship would be discontinued if a hedging instrument were terminated or if a critical term has been modified, which has not occurred. Proponents believe that critical terms have been changed only when there has been a change in the amount and timing of contractual cash flows, whereas all contractual cash flows (i.e., both variation margin and PAI/PA/PAA) have always existed in the overall arrangement. As support for this view, proponents refer to paragraph BC 13 of ASU 2016-05[22] which states that: "critical terms refer to factors that affect the timing and amount of contractual cash flows."

The characterization of variation margin as settlement under the revised rulebooks is legally driven, with the legal position determining the accounting representation of the variation margin amount as a settlement of the MTM exposure rather than a separate collateral payable or receivable amount. In contrast, the considerations for what constitutes a 'critical term' for the purposes of hedge accounting are broader and are driven by the risk position and exposure to the underlying in terms of timing or amount of cash flows. The change in characterization of variation margin amounts as settlement does not impact the terms of the swap which drive its value as it relates to the underlying risk. Under this view, a cleared derivative designated in a hedging relationship should not be discontinued as a result of being re-characterized as an STM contract because the derivative has not been terminated and the contractual cash flows have not been modified. The rulebook changes only result in a basis for a different legal characterization without changing the timing and amount of contractual cash flows when considering the entirety of the arrangement.

Proponents of this view also refer to paragraph BC 11 of ASU 2016-05 which states that: "In reaching its consensus, the Task Force noted that the analysis of whether a derivative instrument has been "terminated" in the context of the hedge accounting guidance in Topic 815 was intended to go beyond a legal determination and instead focus on whether the hedging relationship itself would continue to exist. If the only change to the derivative instrument is the counterparty, the hedging relationship may be largely unaffected. Therefore, "termination" (as that term is used in the hedge accounting guidance in Topic 815) of the derivative instrument will not have occurred." This would be the case even if, as described in BC 12 of ASU 2016-05, there were "changes in security or cash collateral posting requirements". Presuming that the hedge relationship continues to be highly effective, Proponents of this view would argue that additional interim settlements would not result in "termination" of the derivative in the context of hedge accounting.

[22] ASU 2016-05, Derivatives and Hedging (Topic 815), *Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships*

Furthermore, proponents of this view are concerned about the consequences that may be brought about if a de-designation and re-designation (of the hedging relationship) is required pursuant to the rulebook changes. Examples include:

1. Re-documentation of the hedge accounting relationship
2. Evaluation of whether the re-designated hedge relationship continues to meet the criteria under which it originally qualified for hedge accounting
3. Whether the instrument has a more-than-insignificant financing element
4. Construction of a new hypothetical derivative for cash flow hedges and calculation and recognition of ineffectiveness based on the difference between the actual derivative and the new hypothetical derivative. This issue could lead to more income statement volatility and may not reflect the underlying economics of the hedged item/transaction which would not have changed since inception of the original hedge accounting relationship.

Alternative View – Yes, the hedging relationships are required to be discontinued

ASC 815-25-40-1 through 40-2 and ASC 815-30-40-1 through 40-3 provide guidance on the accounting for the discontinuance of fair value and cash flow hedges, respectively. Typically, this occurs when the hedging relationship is no longer highly effective or when the forecasted transaction is no longer probable of occurring as described in the original hedge documentation. Additionally, an entity must cease applying hedge accounting if the derivative hedging instrument expires or the entity sells, terminates, or exercises the instrument, or removes the designation that was formally documented at the inception of the hedge. In addition, ASC 815-20-55-56 states the following:

"If an entity wishes to change any of the critical terms of the hedging relationship (including the method designated for use in assessing hedge effectiveness), as documented at inception, the mechanism provided in this Subtopic to accomplish that change is the de-designation of the original hedging relationship and the designation of a new hedging relationship that incorporates the desired changes."

Proponents of this alternative view believe that changing the accounting for derivatives from CTM to STM (i.e., from separate derivative and collateral units of account to a single unit of account) would result in the addition of cash flows to the hedging instrument (which from a unit of account perspective had previously excluded collateral) as well as the possible introduction of small levels of ineffectiveness to the hedging relationship.

Proponents also considered ASU 2016-05 and refer to the basis for conclusions of the ASU, which states that the hedge accounting guidance refers to critical terms in the context of factors that affect the amount and timing of contractual cash flows. They note that although STM contracts are expected to have cash flows identical to CTM contracts, the STM contracts move cash flows previously related to collateral provisions (such as PAI) into the derivative unit of account. Because the change causes cash flows not previously included in the hedging instrument (derivative transaction) to be incorporated into the derivative unit of account and as similar cash flows are not mirrored in the hedged asset or liability, proponents of this alternative view believe that the hedging relationship would be required to be discontinued.

Some proponents of this alternative view also believe that although there is no clear guidance in Topic 815 that a change in the legal settlement terms of a derivative contract in itself represents a termination and replacement of the instrument or a significant modification of the terms of the instrument, a change in the settlement terms should be viewed as a substantial modification to the derivative instrument which requires discontinuance. In their view this is supported by the fact that the change in settlement terms alters the nature of the cash flows such that they no longer represent posting of collateral and PAI paid on that collateral.

Question 2: After the adoption date, will daily settlements of settled-to-market contracts (both CME and LCH) require daily dedesignation and redesignation of the hedging relationships relating to all derivatives cleared on the respective CCPs?

Conclusion – No

ASC 815-25-40-1 through 40-2 and ASC 815-30-40-1 through 40-3 provide guidance on the accounting for the discontinuance of fair value and cash flow hedges, respectively. Typically, this occurs when the hedging relationship is no longer highly effective or when the forecasted transaction is no longer probable of occurring as described in the original hedge documentation, or if there is a modification to a critical term of the hedging relationship. Additionally, an entity must cease applying hedge accounting if the derivative hedging instrument expires or the entity sells, terminates, or exercises the instrument, or the entity removes the designation that was formally documented at the inception of the hedge.

The payments for outstanding MTM of STM contracts will result in the MTM of the cleared swap position being reset to zero on a daily basis. The settlement does not result in the creation of an entirely new contract or expiration or termination of the existing contract. Future settlements on the contract will continue to occur under the terms of the existing contract. The cleared swap (in the case of an interest rate swap) has a tenor, notional, fixed-rate leg and floating-rate leg that are exactly the same as a bilateral OTC interest rate swap regardless of whether it is collateralized or not.[23] As noted in the Background provided above, the change to the legal characterization of variation margin as settlement does not impact other terms of the swap and there is no reset of the contractual interest rates to prevailing market rates upon the variation margin settlement payment. The swap remains a term instrument where the MTM exposure has been settled at a point in time (i.e., daily). Importantly, STM contracts will have the same cash flows prior to and subsequent to the rulebook changes. Furthermore, as a point of

[23] ASC 815-20-25-11 states that "An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof (hedged item) that is attributable to a particular risk if all applicable criteria are met." Importantly, while US GAAP requires that entities designate the changes in the fair value of the hedge item (and corresponding derivative), it is silent on the settlement mechanism of the hedging instrument and hedged item.

reference, in cases where exchange traded futures contracts are designated in hedge relationships, daily settlement does not trigger a de-designation (and re-designation) event.[24]

The majority of entities discount cleared swaps using OIS[25] curves (which is industry practice), therefore bringing the impact of daily cash flows on cumulative margin balances into the valuation of their contracts. These entities do so for both LCH and CME contracts, regardless of where in the rulebook PAI exists today, and would not view this being impacted by whether PAA/PA going forward is embedded in the contract (as per LCH) or remains a floating component (as per CME).

For firms that do not currently include PAI in the valuation of their hedging contracts, inclusion of PA/PAA in the valuation may introduce a new source of ineffectiveness. However, any resulting changes to the fair value of the contract are expected to be insignificant and should not require de-designation of the existing hedge relationship.

Alternative View – Yes

Proponents of this alternative view believe that, notwithstanding legal opinions to the contrary, daily settlement of CME and LCH derivatives result in a termination and settlement of the existing contract and the entering into of a new contract the next day. While we are not aware of any firms that support this alternative view, application of it would require daily de-designation and re-designation of the hedged relationship.

Question 3: Would an entity be able to apply the "short-cut method" to hedging relationships where the derivative instrument is either a CME cleared contract or STM contract cleared on the LCH?

Conclusion – Short-cut permitted[26]

Proponents of this view believe that hedging relationships using either a CME cleared contract subsequent to the 2016 Rulebook Changes or an LCH STM contract would continue to meet the requirements in ASC 815-20-25-104 through 106 to apply the "short-cut method" for assessing hedge effectiveness and measuring ineffectiveness. Proponents of this view believe that because the total cash flows remain unchanged before and after the CME and LCH rulebook clarifications, although the legal characterization of variation margin has changed, this should not preclude eligibility to utilize the short-cut method because the amount and timing of cash flows and valuation do not change and therefore no new or additional ineffectiveness is introduced.

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[24] Refer to ASC 815-25-55-1 through 7, and ASC 815-25-55-13 through 17 for examples of fair value hedge using futures and ASC 815-30-55-40 through 51 for a cash flow hedge using futures.

[25] Overnight-indexed-swap

[26] We expect a consistent conclusion to be reached for the critical terms match methodology.

Proponents of this conclusion acknowledge that in certain respects, settlement terms of an interest rate swap need to be evaluated in order to apply the short-cut method. Thus, some may take the view that changes to the settlement terms (e.g., when a contract is modified from a CTM to an STM contract) would require de-designation of a short-cut hedging relationship. Proponents of this conclusion that short-cut would still be permitted note that the settlement amounts the short-cut criteria focus on are those related to the fixed and variable legs of the swap calculated off the swap's notional amount.

Some would point out that the inclusion of the variation margin and related PAA amounts in the short-cut analysis may cause the instrument to violate certain criteria to qualify for the short-cut method such as 815-20-25-104(d). Proponents of this conclusion that short-cut is permitted believe that the hedge accounting model within ASC 815 focuses on changes in fair value of the derivative as compared to changes in fair value of the hedged item. Practice has generally interpreted that "clean" values or those that exclude interest accruals are utilized in these analyses. Given that inclusion of variation margin flows and related PAA as a settlement cash flow of the derivative's MTM exposure is not expected to impact fair value modelling for the derivative (as it relates to "clean" values), proponents of this conclusion would propose that variation margin and related PAA cash flows should not be considered in the short-cut analysis. As an example, in analyzing whether the formula for computing net settlements is the same for each net settlement (815-20-25-104(d)) one would focus on the elements of the swap that drive changes in its fair value (i.e., the terms of the fixed and floating legs of the swap and the notional amount that such payments are based on). Under this proposal, the fact that PAA is paid based upon a floating notional (cumulative variation margin) would not be relevant.

We understand that most entities incorporated PAI/PAA/PA and variation margin into the valuation of the derivative prior to the proposals by discounting the contractual cash flows of the derivative at the OIS rate. To the extent that those entities are proponents of this view, they would argue that the determination of the fair value of the derivative already incorporated all of the contractual cash flows prior to the CME and LCH proposals, and therefore, to the extent use of the short-cut was not precluded prior to the proposals, the proposals themselves should not change such conclusions.

Alternative View – No short-cut permitted

Proponents of this alternative view argue that once a contract becomes a STM contract, the variation margin settlement payments and related PAA amounts are part of a single unit of account within the derivative instrument. As such, they believe it would be inappropriate to exclude these payments from the analysis of whether the relationship could qualify for the short-cut method.

Proponents of this view believe that hedging relationships using either a CME cleared contract or an STM LCH cleared contract would not meet the requirements in ASC 815-20-25-104(g) to apply the "short-cut method" for assessing hedge effectiveness and measuring ineffectiveness.

The short-cut method requires that any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and the terms of the instruments do not invalidate the assumption of no ineffectiveness. As a result of the rule change, the cash flows related to PA (for CME contracts subsequent to the 2016 Rulebook Changes) and PAA (for LCH STM contracts) would be incorporated as part of the derivative and may cause ineffectiveness in the hedging relationship as there is no mirror term in the hedged item. As such, the hedging relationship would not meet ASC 815-20-25-104(g) and the hedging relationship would need to be discontinued or would need to utilize the long-haul method for future hedging relationships for assessing ineffectiveness and measuring ineffectiveness.

As noted above, proponents of this view note that a fair value or cash flow hedge using an STM Contract may also not meet the condition in ASC 815-20-25-104(d) which requires the formula for computing net settlements under the interest rate swap to be the same for each net settlement. An interest rate swap must have a constant fixed rate throughout the term and a variable rate based on the same index with constant adjustment or no adjustment in order to satisfy this condition. Net settlement provisions for a STM contract includes daily settlement provisions related to PAA/PA. The formula for calculating the settlement of PAA/PA is determined by the relevant CCP and is based upon cumulative variation margin which changes on a daily basis. As such, a STM Contract may also not satisfy the condition in paragraph 815-20-25-104(d) and the hedging relationship would need to be discontinued if the variation margin and PAA/PA amounts are included in the assessment of terms to be considered when assessing validity of applying the short-cut method.

When proponents of the conclusion that the short-cut method continues to be available consider the alternative view, they believe it is worth noting that the market for derivative instruments is an evolving one and the valuation of such instruments has correspondingly evolved with the market. This includes the incorporation of the PA pricing adjustment into the valuation (via an OIS discount rate) of the derivative to align the uncleared and cleared derivatives and to fairly reflect the pricing of the derivatives in the principle market. The PA amount is a determinable variable, the calculation of which is based on the overnight index and its presence (via an OIS discount rate) does not invalidate the requirement of 815-20-25-104(d).

Appendix

Illustrative journal entries and financial statement presentation of a swap under the CTM and STM models[27]

CTM:

Reporting entity entered into an interest rate swap on 3/1/2016
On 3/29/16, the swap had an opening FV = 95 and closed at FV = 100 (i.e., it had a 5 MTM gain)
Variation margin (VM) is posted daily
Coupons[28] are excluded from this example but would be recorded as gains/losses from principal transactions (Trading P&L)

Journal Entries on 3/29/16:

Entry 1:

DR Derivative asset	5	
CR Trading P&L		5

(To record the 5 MTM gain, gross derivative asset is 100)

Entry 2:

DR Cash	5	
CR Payable Due to CCP		5

(To record the additional VM received for the change in FV from 95 to 100.[29] *Total VM of 100 will be offset against derivative of 100. Balance sheet will reflect a net derivative asset of 0)*

Entry 3:

DR Interest expense (PAI)	.1	
CR Cash		.1

(To record daily PAI on 95 in VM collateral)[30]

[See next page for STM]

[27] Note that this is intended to be illustrative example only. While the exact timing of cash flows between T, T+1 or later may vary depending on CCP or underlying CCY of transactions, the resulting journal entries shown would arise at the relevant time. Further, the financial statement presentation of the journal entries herein may differ by firm.
[28] Coupons refer to the daily accrual of interest calculated as the difference between the fixed and floating interest rate legs of the swap, multiplied by the notional.
[29] VM for the MTM change on 3/29 is received that same day
[30] PAI is calculated/earned at T+1

STM:

Reporting entity is long the same derivative as above (with the same MTM changes). Moves in MTM are settled daily.

The derivative asset opens at FV=0[31] and has a 5 MTM gain by COB 3/29/16.

Coupons are excluded from this example, but would be recorded as gains/losses from principal transactions (Trading P&L).

Journal Entries on 3/29/16:

Entry 1a:

DR Derivative asset[32]	5	
CR Trading P&L		5

(To record the 5 MTM gain on the swap)

Entry 2a:

DR Cash	5	
CR Derivative asset		5

(To record the settlement margin received on the MTM gains and reset the swap to zero)

Entry 3a:

DR Trading P&L	.1	
CR Cash		.1

(To record the daily PAA - this would be based on an aligned amount to a CTM derivative)

Balance sheet presentation

CTM

3/29/16:	Derivative asset	0*

***Derivative will be presented on the balance sheet at 0 after FIN 39 netting:**

	Derivative asset	100
Less:	Payable Due to CCP (cash collateral)	(100)

Note that the disclosures will reflect the FIN 39 netting components shown above.

STM

3/29/16:	Derivative asset	0**

****Derivative will be presented on the balance sheet at 0 after settlement:**

	Derivative asset (MTM)	5
Less:	Settlement margin	(5)

[31] The derivative settles daily and therefore resets to zero daily

[32] There may be diversity in practice with regard to policy decisions on the balance sheet line item classification of this daily amount, which are presentation decisions and do not affect the analysis.

Income statement presentation

CTM

3/29/16: Trading P&L (swap gain)	(5)
3/29/16: Interest expense (PAI)	.1

STM

3/29/16: Trading P&L (swap gain)	(5)
3/29/16: Trading P&L (PA/PAA)	.1