KPMG

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Accounting implications for investment companies: Rule changes for variation margin

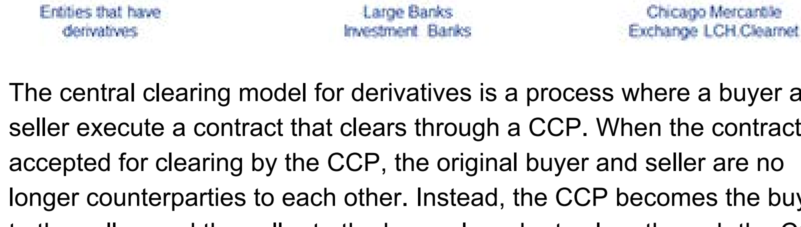
Overview

Effective January 3, 2017, the Chicago Mercantile Exchange (CME) implemented rule changes that characterize certain payments as the legal settlement of outstanding derivative contract exposure rather than as posting of collateral. The rule changes should be reflected prospectively as of the effective date and will primarily affect interest rate swaps and credit default swaps that are centrally cleared through the CME.

We understand that the London Clearing House (LCH) has made similar rule changes, which are currently effective on an elective basis by clearing members (CMS) for their house trades and trades made on behalf of customers. We expect that the LCH rule changes as well as planned rule changes by other central clearing parties (CCPS) will raise considerations similar to those resulting from the CME rule changes.

Background

Following the 2008–2009 financial crisis, several regulators and governments enacted rules to increase liquidity and reduce counterparty credit risk in the over-the-counter (OTC) derivative markets. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires certain end users to clear their derivative transactions through a CCP.



The central clearing model for derivatives is a process where a buyer and a seller execute a contract that clears through a CCP. When the contract is accepted for clearing by the CCP, the original buyer and seller are no longer counterparties to each other. Instead, the CCP becomes the buyer to the seller, and the seller to the buyer. In order to clear through the CCP, initial and variation margin payments are typically posted by CMs and end users, which reduces the CCP's exposure to counterparty risk. In addition, interest associated with variation margin is paid to the party paying variation margin.

Accounting implications

As a result of the rule changes, the legal characterization for payments of variation margin, which generally has been treated as posted collateral (collateralized to market or CTM), will now be in line with actual settlement (settled to market or STM). The potential accounting implications for investment companies are summarized as follows and discussed further below:

Collateralized to market	Settled to market
— Variation margin is recorded separate from the fair value of the derivative asset or liability. — Market exposure is not reset or extinguished by the transfer of collateral. — Some entities separately recognize interest income or expense related to variation margin amounts.	— Payments of variation margin are applied against the market exposure of the derivative contract rather than recorded as separate receivables and payables. — The market exposure is generally close to, or equal to, zero following daily settlement. — Interest related to variation margin will be incorporated into the valuation of derivative contracts.

To prepare for the potential implications related to the rule changes, we recommend that funds assess the adequacy of their policies and procedures to identify their derivative contracts cleared with CCPs subject to the rule changes. In addition, we recommend that funds review their internal controls over the processing and record keeping of their centrally cleared derivatives to ensure that variation margin payments and changes in fair value of derivative contracts are properly recorded and classified in the financial statements.

Unit of account

Prior to the rule changes, receivables and payables for variation margin and the fair value amounts of the related derivative contracts were considered to be separate units of account. Upon the effective date of the rule changes, the parties to the contract will no longer have legal rights to reclaim the collateral amounts paid or received, including the associated interest amounts and/or any price alignment amounts. As a result, these payments no longer represent separate collateral paid or received against the corresponding contract but, rather, are included in the cash flows from the daily settlement of the derivative.

The International Swaps and Derivatives Association (ISDA) , in its confirming letter sent to the SEC staff on January 4, 2017 (the ISDA letter), expressed the view that cash flows related to an STM derivative contract are included in a single unit of account for accounting and presentation purposes. However, this conclusion is based on legal analysis of the characterization of payments exchanged between the CCPs and the CM and does not address the payments exchanged between the CM and its end users. As a result, an end-user fund should consider performing a legal analysis of the characterization of its STM contracts to support its conclusions for the accounting for variation margin as the same unit of account with the related derivative instrument or as a separate unit of account.

Income statement presentation

Following the announcement of the rule changes, diversity in views emerged on the presentation of variation margin payments for futures contracts and other STM derivative contracts within the income statement of investment companies. Many investment companies have followed the industry practice of accounting for the change in the fair value of open futures contracts as unrealized gains or losses until the contracts are closed or mature. This practice has influenced the SEC's financial reporting and regulatory requirements for investment companies.

We understand the SEC staff has stated that they would not object to investment companies applying a consistent accounting policy related to the income statement presentation of gains and losses for centrally cleared derivatives. Investment companies should apply the accounting policy consistently to all derivatives that are centrally cleared and generally should not change as a result of the rule change. An investment company that currently presents the change in fair value of open futures contracts as unrealized gains and losses should continue to apply that accounting policy to all open futures contracts and other centrally cleared STM derivatives. If an investment company elects to change its presentation of changes in fair value from unrealized to realized classification, it should consider whether it can substantiate a change in accounting policy on the basis that it is preferable. A registered investment company considering such a change should consider consulting with the SEC staff prior to electing this change.

While the impact of the rule changes are not expected to affect the overall net assets of a fund, the rule changes may result in changes in income statement classification for certain components of the derivative transaction. For example, some funds may have previously recorded price alignment interest related to variation margin as interest income or expense. However, following the effective date of the rule changes, these amounts are now incorporated into the valuation of derivative contracts as price alignment amounts.

A fund should also consider the impact of changes in income statement classification to ratios or contractual requirements, such as fee arrangements as well as the potential income tax consequences resulting from the changes in the characterization of payments as settlements.

Balance sheet presentation

Funds should understand whether centrally cleared derivatives are STM or CTM in order to determine the appropriate balance sheet presentation, the impact of offsetting, and related disclosures.

The primary balance sheet impact from the rule changes is that variation margin paid or received are no longer recognized as receivables or payables separate from the associated derivative asset or liability. Since variation margin payments characterized as legal settlements are viewed as the same unit of account as the derivative exposure, the fair value for the open derivative contract will generally be close to, or equal to, zero on a daily basis and as of the reporting date.

In addition, the rule changes will also impact the character of offsetting collateral receivables or payables associated with derivative contracts, which are included in disclosures of the effect and potential effect of netting arrangements required under ASC Subtopic 210–20, *Offsetting*.

ASC Topic 815 disclosures

The ISDA letter also expresses the view that STM derivative contracts remain term instruments and the daily settlement of the contracts do not modify the contractual terms of the instrument. Example considerations related to applying the disclosure requirements of ASC Topic 815, *Derivatives and Hedging*, to STM contracts may include, but are not limited to, the following:

- Typically, the open derivative contracts presented in the volume of a fund's derivative activities should not be affected.
- For STM contracts, payments of variation margin will no longer be considered cash collateral for purposes of presenting quantitative disclosures of gross derivative assets and liabilities.
- For STM contracts, there will be significantly lower fair value of derivative assets and derivative liabilities presented due to variation margin included in the same unit of account with derivative balances.

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