Bank Asset/Liability Management

Vol. 32, No.3 March 2016

SCI™

Prepared by Mary Brookhart

Nuances of Novation: Hedge Accounting Considerations

By

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In August 2015, the Financial Accounting Standards Board (FASB) issued an exposure draft relating to the accounting for derivatives and hedging transactions, focusing on the situation where derivative contacts are novated – that is, where "ownership" of one of the parties to the derivative is transferred to a third party. The exposure draft reads "… a change in the counterparty to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, in and of itself, be considered a termination of the derivative instrument." (See ASC 815-25-40-1A.) As might reasonably be expected, all respondents to the FASB's request for comments favored this adjustment.

More recently, in December 2015, the Board announced a tentative decision with the release of Emerging Issues Task Force (EITF) Issue No. 15-D, which relates to this question. This tentative decision, if ratified, appears to clear the way for the uninterrupted application of hedge accounting following novation of the hedging derivative. The opinion would seem to allow the reporting entity to "look through" any transformation of cash flows that may arise as a consequence of the novation, allowing for hedge effectiveness to be evaluated on the basis of the original design of the pre-novated derivative.

For some novation circumstances, this decision reflects an accounting determination that happens to be in conflict with the change in economics that arises as a consequence of the novation.

Financial professionals should appreciate that two distinct types of novation may arise. In the simpler case, a new legal entity steps into the shoes of an original party to the derivative, but all of the cash flow obligations set forth by the original derivative contract are unaffected. In this case, because the economics of the transaction are unchanged by the novation, it's reasonable and appropriate that any measure of ineffectiveness should be unaffected. In contrast, when the novation of a contract fosters a change in cash flow obligations from the pre-novation design, irrespective of any accounting accommodations, the economic outcome of the novated derivative will differ from that which otherwise would have occurred under the prior (pre-novation) treatment.

With the novation of a traditional, bi-lateral over the counter derivative to a clearing platform, the cash flow obligations originally dictated under the pre-cleared instrument design would be over-ridden by daily variation margin settlements required by the clearing

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institution. These daily settlements effectively accelerate payments for unrealized gains and losses. Critically, though, the daily settlements with the clearing entity also include a *price alignment interest (PAI)* component as part of the variation margin amount. PAI serve to compensate the party bearing the liability in amounts intended to replicate the (potential) interest income foregone as a consequence of having to put up cash commensurate with the unrealized loss on the contract. This PAI component of the variation margin, however, is an undifferentiated aspect of the derivative's gain or loss.

The fact that the economics are altered under this type of novation is incontrovertible. Consider, for example a cleared swap versus its precursor -- a standard (not-cleared) OTC swap; and assume both start at market (i.e., with an initial value equal to zero). For the cleared swap, the gain or loss over the life of the contract will be the sum of all of the daily variation settlement amounts, inclusive of PAIs. For traditional (non-cleared) OTC contracts, the life-time gains or losses will simply be the sum of its settlements. These two outcomes won't be the same.

[See Kawaller, "The Evolution of Over-The-Counter Derivatives and Associated Accounting Concerns," *Bank Asset/Liability Management,* January 2015 for a more complete discussion of these issues.]

Despite the change in the economics of this type of novated derivative, under the proposed accounting guidance, reporting entities will still be able to continue hedge accounting without re-designation. Moreover, the proposed EITF guidance goes further by seeming to allow reporting entities to measure ineffectiveness based on the pre-novated critical terms, which, in reality, won't generally apply. Again, original cash flow obligations would be over-ridden or replaced by the daily variation margin adjustments.

A related concern still begs for a clarification from FASB. That is, "What is the correct balance sheet carrying value for cleared swaps that require daily variation margin settlements?" At the heart of this question is a determination as to whether variation margin adjustments are collateral or, instead, settlements against value. If one characterizes variation margin as "cash collateral," the seemingly correct carrying value of the derivative would be an asset or liability value that would be determined on the basis of the present value of anticipated cash flows, independent from any current or anticipated collateral considerations – i.e., the pre-novated value of the derivative. With this treatment, receipt or payment of the cash collateral variation margin presumably would be reflected in cash balances, with a compensating, associated payable or receivable.

On the other hand, if the variation margin is deemed to be a settlement against the value of the cleared derivative, the offset to these cash flows would be to the derivative, itself, identically to the way settlements offset typical payables or receivables. This treatment nets the variation settlements from the derivatives carrying value, each and every day.

It should be clear that the former treatment balloons the balance sheet relative to the latter treatment. Put another way, when variation margin is treated as collateral, the balance sheet either double counts assets and imposes a compensating payable, or it double counts liabilities and imposes a compensating receivable.

To be fair, even those who characterize variation margin as collateral may end up with the same balance sheet carrying value as those who see variation margin as settlements against derivatives' values, provided they make an election to show their derivatives on their balance sheet net the cash collateral settlements. Thus, a discrepancy only applies to those who view variation margin as collateral and decline this netting election.

At this point, accounting practice is divided. Some entities treat variation margin as collateral; others treat it as settlements against derivatives' values. In all likelihood, the presence of the PAI component of the variation margin is the source of the lack of consensus of the accounting treatment. When non-cash collateral is pledged under the terms of the ISDA credit support agreement, the pledger (i.e., the losing derivative counterparty) still owns the collateral, and the pledger enjoys the benefit of any interest that the collateral might generate. The PAI was designed essentially to mimic this economic result – i.e., to allow the posting party of "cash collateral" to earn interest income on their posted amounts.

Still, characterizing variation margin as collateral doesn't make it so. The pledging of collateral is a temporary condition that would be "un-done" or reversed, assuming the successful satisfaction of the contract's obligation, but variation margin settlements don't work that way. With cleared swaps, variation margin supersedes the originally stipulated cash flow obligations, and parties of the transaction should have no expectation that those variation margin settlements will necessarily revert to the original payer. These considerations notwithstanding, for the present, the FASB has not taken a position on this issue, leaving it to the reporting entities and their auditors to make the determination as to which orientation they deem to be more appropriate.

The choice could have significant implications, depending on the magnitude of the derivative positions. Different balance sheet presentations will necessarily yield different measures for traditional financial ratios, such as returns on assets and debt/equity ratios. Additionally, regulatory capital requirements could be calculated differently under these two alternative reporting regimes – a consideration that might be paramount in management's consideration of the alternatives.