

J.P. Morgan’s Response to FASB Statement No. 161 (FAS 161), Disclosures About Derivative Instruments and Hedging Activities (ASC Topic 815)

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This memorandum describes J.P. Morgan’s response and methodology regarding FASB Statement No. 161 (FAS 161), Disclosures About Derivative Instruments and Hedging Activities (ASC Topic 815)

I. SUMMARY

In March 2008, The Financial Accounting Standards Board adopted Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (FAS 161). The Statement, which amends FAS 133, *Accounting for Derivative Instruments and Hedging Activities*, requires all GAAP reporting entities to disclose information intended to enable financial statement users to understand:

1. How and why the entity uses derivative instruments
2. How derivative instruments are accounted for under FAS 133, *Accounting for Derivative Instruments and Hedging Activities*
3. How derivative instruments affect the entity's financial position, results of operations, and cash flows.

The FASB has issued this Statement, in part, as a response to the growing use and complexity of derivative instruments over the past several years. Additionally, there were concerns that the existing disclosure requirements in FASB Statement No. 133 did not provide enough information to convey in a meaningful way the purpose of derivative use, in terms of the risks that an entity is intending to manage.

The new disclosure guidance applies to all interim and annual reporting periods for which a statement of financial position (e.g., balance sheet) and statement of financial performance (e.g., income statement) are presented. Some of the more significant disclosure requirements include the following:

- An entity's objectives for holding or using derivative instruments and its strategies for achieving those objectives discussed in the context of the instrument's primary underlying risk exposure (e.g., interest rate risk, credit risk, foreign exchange rate risk, equity risk)
- The level of an entity's derivative activity (e.g., total notional amount of contracts outstanding during the period)
- The location and fair value amounts of derivative instruments, hedged items, and related gains and losses in the balance sheet and income statement, presented in a tabular format
- The existence and nature of credit-risk-related contingent features and the circumstances in which those features could be triggered in derivative instruments that are in a net liability position at the end of the reporting period

The scope of FAS 161 is identical to the scope of FAS 133. Accordingly, FAS 161 applies to all entities, including not-for-profit organizations, defined benefit pension plans, and mutual fund companies that have the following:

- Derivative instruments described in paragraphs 6-9 of FAS 133. These include: swaptions, swaps, futures contracts, currency forward contracts, and options (written and purchased)
- Non-derivative instruments that qualify and are designated as hedging instruments pursuant to paragraphs 37 and 42 of FAS 133
- Related hedged items designated in qualifying hedging relationships under FAS 133

Paragraphs 6 -10 of FAS 133 state:

Derivative Instruments

6. *A derivative instrument is a financial instrument or other contract with all three of the following characteristics:*
 - a. *It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.*
 - b. *It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.*
 - c. *Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.*
7. *Underlying, notional amount, and payment provision. An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.*
8. *Initial net investment. Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying.*
9. *Net settlement. A contract fits the description in paragraph 6(c) if its settlement provisions meet one of the following criteria:*
 - a. *Neither party is required to deliver an asset that is associated with the underlying or that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.*
 - b. *One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.*
 - c. *One of the parties is required to deliver an asset of the type described in paragraph 9(a), but that asset is readily convertible to cash or is itself a derivative instrument. An example of that type of contract is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another example is a swaption—an option to require delivery of a swap contract, which is a derivative*

The disclosure requirements of FAS 161 distinguish between derivatives which are accounted for as “hedges” under FAS 133 and those that do not qualify for such accounting. For derivative instruments designated as hedging instruments, the descriptions in the disclosure are required to distinguish between those derivative instruments designated as fair value hedges, cash flow hedges, or net investment hedges. Entities may elect to provide additional information, such as the various types of derivative instruments used to manage each type of primary underlying risk, or the specific exposures within each underlying risk category (e.g., exposures to specific foreign currencies).

Because most pension plans and other postretirement accounts value their derivatives at fair value and recognize changes in fair value through the statement of operations, they do not qualify for FAS 133 hedge accounting. Accordingly, even though an entity’s investments in derivatives may represent economic hedges, they are considered to be non-hedge transactions for purposes of FAS 161 disclosure. ***The remainder of this paper, and the J.P. Morgan reporting solution, assumes that derivatives are not treated under the Hedge Accounting rules.***

NOTE:

Accounting standards in this document include references to the original FASB statements as well as the corresponding Accounting Standards Codification (ASC). FASB ASC disassembled and reassembled original accounting pronouncements (including those of FASB, the EITF, and the AICPA) to organize them under approximately 90 topics. Effective on July 1, 2009, FASB ASC now uses a topical structure in which guidance is organized into areas, topics, subtopics and subsections (e.g., 815-10-50-1).

Please note that this document has been prepared for J.P. Morgan's clients for informational purposes only and is subject to change. It is not intended to provide, and should not be relied on for accounting, investment, tax or legal advice. J.P. Morgan clients should consult their own accountants, lawyers or other experts for specific advice.

II. FAS 161 DISCLOSURES

Disclosure of Objectives and Strategies for Using Derivative Instruments (815-10-50-1)

FAS 161 amends paragraph 44 of FAS 133 to require an entity that holds or issues derivative instruments to disclose its objectives for using them and its strategies for achieving those objectives. To encourage more transparent communication of how and why entities use derivatives to manage their risks, the FASB (“the Board”) decided to require that the instruments be discussed in the context of each instruments' primary underlying risk:

- Interest rate risk
- Credit risk
- Foreign exchange rate risk
- Equity risk
- Commodity risk
- Other contracts

The Board clarified in its deliberations that disclosing objectives and strategies for using derivative instruments by primary underlying risk is the minimum required disclosure. Entities may deem it appropriate to provide additional information, such as information on different types of derivative instruments used for each type of primary underlying risk.

Disclosure of an Entity's Volume of Derivative Activity (815-10-50-4A)

An entity that holds or issues derivative instruments is also required to disclose information that would enable users of its financial statements to understand the volume of its derivative activity. For example, information about an entity's volume of derivative activity might include the total notional amount of credit derivatives outstanding during the period. Initially, the Board considered requiring disclosure of the notional amounts associated with derivative instruments. However, many respondents to the exposure draft stated their concern that notional amounts, in and of themselves, have limited usefulness for indicating the magnitude of the risks being managed. The information on notional amounts could be misleading because the gross presentation does not appropriately reflect the effect of some common strategies. The Board acknowledged the concerns about the limited usefulness of the disclosure of notional amounts, but, they still believe that information about an entity's volume of derivative activity is useful. ***The Board ultimately decided to require a disclosure about volume of activity, but, did not prescribe a specific form and content.***

Topic 815-10-50-1B states:

... an entity shall select the format and the specifics of disclosures relating to their volume of derivative activity that are most relevant and practicable for their individual facts and circumstances.

Initial feedback, based on industry observations is that reporting entities may choose to utilize notional held at the end of the reporting period or average notional (e.g., swaps) and average contract amount outstanding (e.g., forward contracts).

Required Disclosure in Tabular Format (815-10-50-4A)

FAS 161 requires a minimum of two disclosure tables in each annual and interim reporting period for which a balance sheet and income statement is presented. These two tables should include the following:

- Location and fair values of derivative instruments included in the balance sheet
- Location and amount of gains and losses on derivative instruments and related hedged items included in the income statement

The derivative instruments are required to be segregated by major type of instrument (e.g., interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, and credit contracts). The Board decided to prescribe a tabular format for the disclosures because it felt that using tables would improve the transparency of the accounting for derivatives would help users of financial statements understand the effects of derivatives on an entity's financial position, results of operations, and cash flows.

Balance Sheet Disclosures

FAS 161 requires disclosure of the fair value amounts of derivatives and where those fair values are reported in the balance sheet. FAS 161 is prescriptive about the level of aggregation of fair value amounts that should be included in the disclosure tables. In aggregating the fair values of derivatives in the table:

- Derivative instruments in asset positions at the end of the reporting period should be presented separately from instruments in liability positions at the end of the reporting period
- Derivative instruments should be presented on a gross basis
- Collateral amounts associated with derivative instruments should be excluded

The Board expressed its belief that disclosing the fair value amounts on a gross basis would help users understand how and why an entity uses derivative instruments. The Board was concerned that disclosing information on a net basis could make it difficult to analyze (1) the risks being managed with derivatives and (2) the relationship between the fair values of derivatives and the associated gains or losses reported. Because FAS 161 requires the tabular disclosure to be prepared on an instrument-by-instrument level basis that disregards the effect of netting arrangements and collateral positions, it is possible that individual amounts included in the disclosure will not tie to the amounts presented in the balance sheet. The Board accepted this potential inconsistency between the gross amounts disclosed in the footnote and those presented net in the balance sheet because the alternative of disclosing information on a net basis could provide misleading information about the types of risks being managed with derivatives.

Although not required by FAS 161, entities may wish enhance their FAS 161 disclosures by including a reconciliation of the amounts in the disclosure table to the amounts in the balance sheet.

Income Statement Disclosures

FAS 161 requires disclosure of the amount of gains and losses (realized gains/losses and change in unrealized gains/losses) for derivative instruments and related hedged items and where those amounts are reported in the income statement. The disclosure requirement includes tabular presentation, provided in separate columns of gains and losses by type of derivative contract (e.g., interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts).

The income statement table does not require the disclosure of gains and losses on derivatives to distinguish between those that exist at the end of the reporting period and those that are no longer held at the end of the reporting period. In the exposure draft, the Board proposed requiring separate disclosure of the gains and losses based on whether the related derivative instrument was held at period end. However, the Board determined that such a disclosure would prove too voluminous for entities to prepare and would not be particularly useful to financial statement users.

Disclosure of Existence and Nature of Contingent Features (815-10-50-4H)

FAS 161 requires entities to disclose information about the existence and nature of credit-risk-related contingent features (e.g., a material adverse change clause or payment acceleration clause) in derivative instruments for every annual and interim reporting period in which a balance sheet is presented. These disclosures include the following:

1. The existence and nature of credit-risk-related contingent features and the circumstances in which the features could be triggered in derivative instruments that are in a net liability position at the end of the reporting period
2. The aggregate fair value amounts of derivative instruments that contain credit-risk-related contingent features that are in a net liability position at the end of the reporting period
3. The aggregate fair value of assets that are already posted as collateral at the end of the reporting period and the aggregate fair value of additional assets that would be required to be posted as collateral and/or the aggregate fair value of assets needed to settle the instrument immediately, if the contingent features were triggered

The disclosure is intended to provide information about the timing and likelihood of those contingencies occurring, and the magnitude of the impact that credit-risk-related contingency features could have on an entity's financial position, results of operations, and cash flows, particularly on an entity's liquidity. Derivative instruments often contain credit-risk-related contingent features that could result in an immediate payment to the counterparty. For example, a material adverse change clause could provide the counterparty with the right to early terminate the derivative agreement. Alternatively, it could provide a basis for renegotiating the agreement if specific events occur, such as a downgrade of the entity's credit rating below investment grade. These provisions may include an obligation to post additional collateral in instances where the credit-risk contingent feature is triggered or the counterparty is provided the right to terminate the agreement early.

Disclosure of Counterparty Credit Risk

FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (originally issued in December 1991), required that an entity disclose all significant concentrations of credit risk arising from financial instruments. However, diversity in practice has developed as to whether those disclosure requirements should also be applied to derivative instruments. FAS 161 amends FAS 107 by adding a footnote to clarify that derivative instruments accounted for under FAS 133 are include within the scope of FAS 107.

The amendment to FAS 107 states:

An entity shall disclose all significant concentrations of credit risk arising from all^{3a1} financial instruments, whether from an individual counterparty or groups of counterparties. Group concentrations of credit risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. The following shall be disclosed about each significant concentration:

- a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration*
- b. The maximum amount of loss due to credit risk that, based on the gross fair value of the financial instrument, the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity*
- c. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments*
- d. The entity's policy of entering into master netting arrangements to mitigate the credit risk of financial instruments, information about the arrangements for which the entity is a party, and a brief description of the terms of those arrangements, including the extent to which they would reduce the entity's maximum amount of loss due to credit risk.*

^{3a1} Throughout this paragraph, the term financial instruments includes derivative instruments accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

III. WHAT YOU CAN EXPECT FROM J.P. MORGAN

To assist you in compiling the required tabular disclosure, J.P. Morgan has created a suite of reports designed to provide complete detail-level and summary-level (disclosure-ready) information to support the required balance sheet and income statement disclosures. For the income statement disclosures, J.P. Morgan has created two separate summary tables, the first for 'Change in Unrealized Gains and Losses' and the second for 'Realized Gains and Losses'. In addition to the 'Primary Risk Exposure Categories', this presentation of the disclosure includes the major categories of derivatives. The J.P. Morgan reporting solution includes the following reports:

- Derivative Disclosures - Schedule of Investments
- Derivative Disclosures - Change in Unrealized Gain-Loss
- Derivative Disclosures - Realized Gain-Loss

J.P. Morgan has assigned a Risk Exposure Category to all derivative holdings in our clients' accounts, including those required for the Realized Gain/Loss Income Statement disclosures. This was accomplished by utilizing asset categorization data for the derivatives in the J.P. Morgan accounting system and mapping these asset categories to one of the five Risk Exposure Categories.

FAS 161 Report Guides

Please see *Appendix: FAS 161 Report Guides* for a detailed overview of the FAS 161 reports available through the J.P. Morgan ACCESS Web portal.

IV. FREQUENTLY ASKED QUESTIONS

What values are disclosed in the J.P. Morgan reports for each type of derivative?

The summary-level reporting level reporting discloses the following:

Security/Financial Instrument Type	Disclosure Value
Futures Contracts	Total Unrealized Gain-Loss
Option – Written/Purchased	Market Value
Swaps	Total Unrealized Gain-Loss
Forward Currency Contracts	Total Unrealized Gain-Loss

Why is the Total Unrealized Gain/Loss disclosed for futures and swaps?

Won't this presentation differ from other balance sheet disclosure for those assets?

Based on J.P. Morgan's understanding of industry best practices, the recommended disclosure value for futures should be the total unrealized gain/loss (as opposed to unsettled variation margin) and for swaps it should also be the total unrealized gain/loss (as opposed to market value based on notional amount). J.P. Morgan clients should consult their own accountants, lawyers or other experts for specific advice.

FAS 161 requires that derivatives be disclosed on a gross rather than net basis. It also requires financial statement preparers to disregard the effect of netting agreements and collateral positions. The FASB did acknowledge that amounts included in this disclosure will not tie to other balance sheet presentations.

Will J.P. Morgan be able to support the additional footnote disclosures for derivative volume, contingent features in derivatives and counterparty credit risk?

FASB decided not to prescribe a specific method for the disclosure of the Volume of Derivative Activity. Management judgment and decision will be required to determine the type and level of detail of this disclosure. Should our clients elect to use notional amount held at the end of the reporting period to meet this requirement, the reports J.P. Morgan has prepared contains notional/contract amounts for all derivative instruments and could be used for this purpose.

J.P. Morgan does not receive or maintain the source data required to assist clients with the disclosures of contingent features or counterparty credit risk. Clients may wish to consult their asset managers for support of this disclosure requirement.

How did J.P. Morgan map each derivative to one of the Risk Exposure Categories?

J.P. Morgan maintains a detailed asset classification listing for derivatives. This detailed listing was used to map to the Risk Exposure Category. The table below does not contain all of the detailed asset classification that J.P. Morgan maintains; however, at a less granular level it demonstrates the basic matrix methodology that was used to map each type of derivative to the Risk Exposure Categories.

Security/Financial Instrument Type	FAS 161 Risk Exposure Category
Option – Written/Purchased	
Equities	Equity Contracts
Indexes – Equity	Equity Contracts
Indexes – Debt	Interest Rate Contracts
Futures	Classified by the type of underlying future
Currencies	Foreign Exchange Contracts
Treasuries	Interest Rate Contracts
Swaptions	
Credit Default	Credit Contracts
Interest Rate	Interest Rate Contracts
Total Return	Classified by the type of underlying
Currency	Foreign Exchange Contracts
Swaps	
Credit Default	Credit Contracts
Interest Rate	Interest Rate Contracts
Total Return	Classified by the type of underlying security
Currency	Foreign Exchange Contracts
Futures Contracts	
Treasuries	Interest Rate Contracts
Municipal Bond Indexes	Interest Rate Contracts
Equity Indexes	Equity Contracts
Commodities	Commodity Contracts
Individual Stocks	Equity Contracts
Foreign Bonds	Interest Rate Contracts
Forward Currency Contracts	Foreign Exchange Contracts

How do I obtain access to the FAS 161 reports?

Clients with access to J.P. Morgan's Views Portfolio Reporting system (available through the J.P. Morgan ACCESSSM Web portal) will receive entitlement to the three FAS 161 disclosure reports. If you do not have access to the system or do not have entitlement to these reports, please contact your Relationship Manager or Client Service Representative.

How long after the fiscal year-end period will these reports and data for these reports be available?

The reports and the data for the reports can be available as early as the business day following your fiscal-year-end accounting close.

V. APPENDIX: FAS 161 REPORT GUIDES

[FAS 161 Report Guide – Derivatives Disclosure](#)