

J.P. Morgan’s Response to GASB Statement No. 53, Accounting and Financial Reporting for Derivative Instruments

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This memorandum describes J.P. Morgan’s response and methodology regarding GASB Statement No. 53
Accounting and Financial Reporting for Derivative Instruments

I. SUMMARY

In June 2008, The Government Accounting Standards Board issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. The objective of this Statement, which supersedes a number of previously adopted Statements and Technical Bulletins, is to enhance the usefulness and comparability of derivative instrument information reported by state and local governments.

The new disclosure guidance applies to the annual reporting period 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:

- 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 level of an entity's derivative activity (e.g., total notional amount of contracts outstanding at the end of the reporting period)
- Footnote disclosure of risks (e.g. credit, interest rate, foreign currency) associated with derivatives that could give rise to financial loss
- 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

SCOPE

Derivatives in scope of the Statement are defined by GASB as a financial instrument of other contract that has all of the following characteristics:

- a. *Settlement factors*. It has (1) one or more reference rates and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement and, in some cases, whether or not a settlement is required.
- b. *Leverage*. 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 changes in market factors.
- c. *Net Settlement*. 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 a net settlement.¹

¹ Settlement factors, leverage and net settlement are more fully defined in paragraphs 9-13 of the GASB 53 Implementation Guide.

Financial Instruments not included in the scope of the Statement include:

1. Normal purchases and normal sales contracts
2. Insurance contracts
3. Certain financial guarantee contracts
4. Certain contracts that are not exchange-traded
5. Loan commitments

The GASB 53 disclosure requirements distinguish between derivatives which are accounted for using hedge accounting rules and derivatives that are used for investment only. 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 and/or cash flow hedges.

The largest section of the Statement describes the general circumstances under which a derivative is considered a hedging derivative instrument, items that may be hedged and the specific methods for evaluating whether a potential hedging derivative instrument is effective. The public entities for which J.P. Morgan provides accounting services value their derivatives at fair value and recognize changes in fair value through the statement of operations; they do not qualify for hedge accounting. Accordingly, even though an entity's investments in derivatives may represent economic hedges, they are considered investment derivative instruments and are considered to be non-hedge transactions for purposes of GASB53 disclosure. ***The remainder of this paper, and the J.P. Morgan reporting solution, assumes that derivatives are not accounted for as "hedges".***

EFFECTIVE DATE

The requirements of Statement 53 are effective for financial statements for periods beginning after June 15, 2009.

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's clients should consult their own accountants, lawyers or other experts for specific advice.

II. GASB 53 DISCLOSURES

Summary Information

GASB requires governments to provide a summary of their derivative instrument activity during the reporting period and at the end of the reporting period. The information disclosed should be organized by governmental activities, business-type activities, and fiduciary funds. The information should then be divided into the following categories: (1) hedging derivative instruments, and (2) investment derivative instruments. Within each category, derivative instruments should be aggregated by type (e.g. swaps, swaptions, rate caps, futures contracts). Information in the summary should include:

- a. Notional amount
- b. Changes in fair value during the reporting period and the classification in the financial statements where those fair values are reported.
- c. Fair values as of the end of the reporting period and the classification in the financial statements where those fair values are reported. If derivative instrument fair values are based on anything other than quoted market prices, the methods and significant assumptions used to estimate those fair values should be disclosed.
- d. Fair values of derivative instruments reclassified from a hedging derivative instrument to an investment derivative instrument. There also should be disclosure of the deferral amount that was reported within investment revenue upon the reclassification.

Disclosure of this information may be in a table, in narrative form, or a combination of both.

GASB Illustrative Example of Summary Disclosure

	Changes in Fair Value		Fair Value at June 30, 20X0		
	Classification	Amount	Classification	Amount	Notional
Governmental activities					
Fair value hedges:					
Receive-fixed interest rate swap	Deferred inflow	\$ (277)	Debt	\$ 1,572	\$30,000
Cash flow hedges:					
Pay-fixed interest rate swaps	Deferred outflow	\$ (143)	Debt	\$ (1,330)	\$84,000
Rate cap	Deferred inflow	\$ 28	Debt	\$ 377	\$10,000
Investment derivatives:					
Pay-fixed interest rate swap	Investment revenue	\$ 1,277	Investment	\$ (1,277)	\$18,000
Business-type activities					
Cash flow hedges:					
Pay-fixed interest rate swap	Deferred inflow	\$ (548)	Debt	\$ 4,238	\$37,000
Commodity forward	Deferred inflow	\$ (111)	Derivative Instruments	\$ 111	1,000 MMBTUs
Fiduciary funds					
Investment derivatives:					
Foreign currency forward	Investment revenue	\$ 721	Investment	\$ (721)	\$20,000

Additional Notes to Financials

- 1) **Risk Disclosures** – For derivatives held at the end of the reporting period, governments must disclose their exposure to the following risks that could give rise to financial loss:
 - a) Credit risk. The credit risk disclosure does not include exchange-traded derivatives. The government should include the following:
 - i) The credit quality ratings of counterparties
 - ii) The maximum amount of loss due to credit risk that the government would incur if the counterparties to the hedging derivative instrument failed to perform according to the terms of the contract (without regard to collateral or netting arrangements).
 - iii) The government's policy of requiring collateral or other security to support derivatives subject to credit risk, a summary description and the aggregate amount of the collateral and information about the government's access to that collateral.
 - iv) The government's policy of entering into master netting arrangements, including a summary description and the aggregate amount of liabilities included in those arrangements.

- v) The aggregate fair value of hedging derivative instruments in asset positions net of collateral pledged posted by the counterparty and the effect of master netting arrangements.
 - vi) Significant concentrations of net exposure to credit risk.
- b) Interest rate risk. The government should disclose this exposure consistent with the disclosures required by Statement 40, paragraphs 14 and 15.
- c) Foreign currency risk. The government should disclose this exposure consistent with the disclosures required by Statement 40, paragraph 17.
- 2) **Disclosure of Existence and Nature of Contingent Features** – GASB 53 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 those 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.

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

To assist you in compiling the required summary disclosure, J.P. Morgan has created a report designed to provide complete detail-level and summary-level investment derivative information as required by the Statement.

IV. FREQUENTLY ASKED QUESTIONS

What values are disclosed in the J.P. Morgan report 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
Swaptions	Market Value
Swaps	Total Unrealized Gain-Loss
TBAs	Market Value
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.

GASB 53 requires that financial statement preparers disregard the effect of netting agreements and collateral positions.

In the development of our reporting solution, J.P. Morgan did consult with the GASB Staff and received affirmation on the values listed above that should be disclosed for the various derivative instrument types.

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

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.

What is the expectation on the level of detail required for ‘derivative type’ in the GASB53 tabular disclosure?

The illustrative example provided by GASB includes derivative descriptions such as receive-fixed interest rate swaps, pay-fixed interest rate swaps, and forward currency forward. J.P. Morgan inquired with the GASB Staff regarding the requirement for the level of detail that should be disclosed. The Staff confirmed that the illustrative example was only a sample and was not prescriptive. Reporting entities will need to determine the level of detail to disclose that best describes their derivative holdings.

J.P. Morgan will report the most detailed derivative descriptions that are maintained in the accounting system. *Appendix B: Derivative Descriptions* contains the complete list of descriptions that will be used in the disclosure reporting. Currency Forward Contracts will be reported at the currency level.

Are currency spot contracts as well as forward contracts required to be disclosed?

Based on J.P. Morgan’s understanding of industry best practice and based on discussions with the GASB Staff, J.P. Morgan does not believe that spot currency contracts are required to be disclosed in GASB 53 reporting. Spot currency contracts are used primarily for trade settlement and currency repatriation and are valued at spot (traded) currency rates. Forward currency contracts are valued at interpolated forward rates and are generally used to hedge currency risk for changes in value associated with foreign holdings, payables and/or receivables. These contracts should be considered investment derivatives for purposes of GASB 53 reporting.

J.P. Morgan clients should consult their own accountants, lawyers or other experts for specific advice

How do I obtain access to the GASB 53 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 GASB 53 disclosure report. 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 will be available as early as the business day following your fiscal-year-end accounting close.

APPENDIX A. [GASB 53 Report Guide](#)

Appendix B: J.P. Morgan Derivative Descriptions

FUTURES	
BOND INDEX FUTURES	EQUITY INDEX FUTURES
COMMODITY FUTURES	INTEREST RATE FUTURES
CURRENCY FUTURES	
OPTIONS	
BOND INDEX CALL OPTION	EQUITY PUT OPTION
BOND INDEX PUT OPTION	FOREIGN CURRENCY INDEX CALL OPTION
COMMODITY CALL OPTION	FOREIGN CURRENCY INDEX PUT OPTION
COMMODITY INDEX CALL OPTION	FUTURE COMMODITY CALL OPTION
COMMODITY INDEX PUT OPTION	FUTURE COMMODITY PUT OPTION
COMMODITY PUT OPTION	FUTURE CURRENCY CALL OPTION
CREDIT INDEX CALL OPTION	FUTURE CURRENCY PUT OPTION
CREDIT INDEX PUT OPTION	FUTURE EQUITY INDEX CALL OPTION
CURRENCY CALL OPTION	FUTURE EQUITY INDEX PUT OPTION
CURRENCY PUT OPTION	FUTURE INTEREST RATE CALL OPTION
EQUITY CALL OPTION	FUTURE INTEREST RATE PUT OPTION
EQUITY INDEX CALL OPTION	INTEREST RATE CALL OPTION
EQUITY INDEX PUT OPTION	INTEREST RATE PUT OPTION
SWAPTIONS	
BOND INDEX SWAPTION	CURRENCY SWAPTION
COMMODITY INDEX SWAPTION	EQUITY INDEX SWAPTION
CREDIT DEFAULT SWAPTION	FOREIGN CURRENCY INDEX SWAPTION
CREDIT INDEX SWAPTION	INTEREST RATE SWAPTION
SWAPS	
BOND INDEX SWAP	FORWARD RATE AGREEMENTS (FRA)
BOND INDEX TRS	INFLATION LINKED SWAPS (ILS)
COMMODITY INDEX SWAP	INTEREST RATE SWAPS (IRS)
COMMODITY INDEX TRS	PRICE LOCK SWAPS (PLS)
CONSTANT MATURITY SWAPS (CMS)	SPREAD LOCK SWAPS (SPS)
CREDIT DEFAULT SWAPS (CDS)	VARIABLE RATE SWAP (VRS)
CREDIT INDEX SWAP	VARIANCE COMMODITY INDEX SWAP
CREDIT INDEX TRS	VARIANCE EQUITY INDEX SWAP
CURRENCY SWAPS (CS)	VARIANCE BOND INDEX SWAP
EQUITY DEFAULT SWAPS (EDS)	VARIANCE FORWARD CURRENCY SWAP
EQUITY INDEX SWAP	VOLATILITY COMMODITY INDEX SWAP
EQUITY INDEX TRS	VOLATILITY EQUITY INDEX SWAP
EQUITY SWAPS (ES)	VOLATILITY BOND INDEX SWAP
FOREIGN CURRENCY INDEX SWAP	VOLATILITY FORWARD CURRENCY SWAP
FOREIGN CURRENCY INDEX TRS	ZERO COUPON SWAPS (ZCS)
TBAs	
FNMA TBA	GNMA TBA
FNMA TBA ARM	GNMA I TBA
FHLMC GOLD TBA	GNMA I TBA ARM
FHLMC GOLD TBA ARM	GNMA II TBA
FHLMC TBA	GNMA II TBA ARM
FHLMC TBA ARM	