

Accounting for initial margin under IFRS 13

Initial margin (IM) is required by central counterparties and regulations. Chris Kenyon and Richard Kenyon provide an analysis of International Financial Reporting Standard 13, which indicates margin valuation adjustments should be reflected in fair value since exiting affected trades requires the acquiring institution to face the same cost drivers from IM. Furthermore, these project costs contractually resemble the credit support annex costs routinely included in pricing

Initial margin (IM) is required by central counterparties (CCPs). From September 1, 2016, IM is being introduced between institutions trading financial derivatives in accordance with international regulations (BCBS-317; see BCBS/Iosco (2015)), which provides a new impetus to assess whether the lifetime cost of IM, known as margin valuation adjustment (MVA; see Green & Kenyon (2015)), is an acceptable component of fair value for accounting purposes. We assess a series of arguments based on International Financial Reporting Standard 13 (IFRS 13; see IASB (2016c)) and the Companies Act 2006¹ to understand and evaluate the place of MVA as a component of accounting fair value. Our evaluation suggests the inclusion of MVA within fair value is required by IFRS 13 and the Companies Act 2006. We then turn to its accounting treatment, offering an assessment of its inputs and alternatives for the applicable unit of account and aggregate reporting.

Margin requirements are contractually embodied in various documents: the credit support annex (CSA) for variation margin (VM), the credit support deed (CSD) and clearing arrangements (CAs) for IMs (which are dynamic despite the name). CSA and CSD/CA can be regarded as financial derivatives in their own right, as they are long-running contracts with periodic and/or event-driven (contingent) cashflow. Piterbarg (2010, 2012) showed by no-arbitrage and replication that when a CSA is present it defines the appropriate discount rate for the derivatives it covers. Common practice is to include the CSA cost directly in each derivatives price. The CSA effect can also be priced separately when trades are priced assuming no CSA. It is not necessary for CSAs to be included in the pricing of individual trades in order to capture their economic effect, but it is mathematically convenient. Operationally, there are arguments both ways.

Similarly to Piterbarg's work on CSAs, Green & Kenyon (2015) provided no-arbitrage and replication pricing of the lifetime cost of CSD/CA. However, the pricing effect of IM over the life of a trade (MVA) usually cannot be embedded simply in the discount factor for trades covered by a CSD/CA. For example, Isda's standard initial margin model (Simm) methodology (which answers the BCBS-317 requirement) builds up the IM amount using a hierarchical variance-like approach that cannot be calculated separately for individual trades. In addition, MVA has portfolio effects that change option exercise decisions and potentially increase the size of the state space exponentially relative to the number of option trades and exercise decision dates (Green & Kenyon 2017). Thus, MVA is usually computed for the set of trades covered by a CSD/CA as a valuation adjustment on their price, including CSA (trades in this case will have

both a CSA and a CSD). Some forms of MVA can be efficiently attributed back to individual trades (Kenyon & Green 2015).

Typically, the definition of economic value, also known as the adjusted derivative value or portfolio value, $\hat{V}$, is written as:

$$\hat{V} = V + U$$

where V is the unadjusted (or riskless) value and U is the total effect of all adjustments.

Present value methods for calculating $\hat{V}$ based on replication and no-arbitrage, including many valuation adjustments, are available (Green 2015; Lichters *et al* 2015) and can be readily extended to new ones (Kenyon & Green 2016). The main valuation adjustments capture the effects of credit, funding and capital. The valuation adjustment for IM, MVA, is a recent addition to the pricing literature (Green & Kenyon 2015), so it is unsurprising that it is not yet an accepted part of bank accounting. Accountants and hence accounting rely on subject matter experts; originality and creativity in accounting is not encouraged by investors (Cannon *et al* 2009).

A key feature of MVA is that it is a holding cost, so, absent significant asymmetry in market power, this means liquid mid-market transaction prices will not represent economic value. We demonstrate below that accounting has provision for this, and provide details on how to deal with it using examples and recommendations.

The purpose of this article is to show how to assess whether the lifetime cost of IM (MVA) is an acceptable component of fair value for accounting purposes, as well as how to account for it and how to deal with it in new trade pricing. We start with a synopsis of the relevant parts of IFRS and the Companies Act 2006, and demonstrate that naive application of the exit price concept of IFRS 13 can give a false representation of the financial position. We then show how to apply the exit price concept to give an accurate representation of the financial position, and we provide suggestions as to its incorporation into new trade pricing. Finally, we describe how to apply this valuation in financial accounting for published financial statements.

Accounting for margin valuation adjustment

To begin, we provide some accounting context in terms of the most significant regulations (IFRS 9, IFRS 13) and laws (Companies Act 2006). After this, we assess arguments as to whether MVA should be part of fair value and reported in accounts.

For clarity, we will consider interest rate swaps (IRSs) as an example. When IRSs are vanilla, they are likely to be centrally cleared. When they are not vanilla (eg, irregular timing, non-standard indexes versus frequency), they will be traded bilaterally.

¹ See www.legislation.gov.uk/ukpga/2006/46/section/393

■ **Accounting context.** Under IFRS 9 ('financial derivatives'), financial derivatives are usually valued by irrevocable choice at inception using fair value through profit and loss (FVTPL). IFRS 13 defines fair value and replaces the requirement contained in individual standards (IASB 2016c). In addition, section 393 of the UK Companies Act 2006 states:

- (1) The directors of a company must not approve accounts for the purposes of this chapter unless they are satisfied that they give a true-and-fair view of the assets, liabilities, financial position and profit or loss.
- (2) The auditor of a company in carrying out [their] functions under this Act in relation to the company's annual accounts must have regard to the directors' duty under subsection (1).

This is known as the true-and-fair override. If accounting standards do not result in a true-and-fair view of the financial position and/or results of the accounting period, then a true-and-fair view must still be presented, and the company auditors are responsible for taking this into account. In general, it is expected that accounting regulation will give a true-and-fair view, but this may not be the case when a field is developing. The Financial Reporting Council (the UK government regulator on financial reporting) has obtained legal confirmation that the true-and-fair override applies to derivatives accounting (Moore 2013).

IFRS 13 is comprised of 99 paragraphs, each of which has equal 'authority' (IFRS 13, page A603), and appendices A–D, which form an integral part of the standard. IFRS 13 defines fair value as an exit price (paragraphs 2 and 9):

This IFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The characteristics of the asset or liability must be taken into account (paragraph 11):

A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, for example, the following:

- (a) the condition and location of the asset; and
- (b) restrictions, if any, on the sale or use of the asset.

Thus, the characteristics and location of a trade – ie, that it is with a CCP or with an entity that is subject to bilateral IM – should be taken into account.

IFRS 13 refers to the fair value of the transaction above using a mix of entity-independent and entity-specific considerations. Entity-independent language, emphasising market-based pricing and what participants typically consider, can be found in paragraph 2:

Fair value is a market-based measurement, not an entity-specific measurement.

It also appears in paragraph 3:

Because fair value is a market-based measurement, it is measured using the assumptions that market participants would

use when pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.

Market participants are independent, knowledgeable and (appendix A):

- (d) They are willing to enter into a transaction for the asset or liability, ie, they are motivated but not forced or otherwise compelled to do so.

This contrasts with entity-specific considerations, for example (paragraph 19):

The entity must have access to the principal (or most advantageous) market at the measurement date. Because different entities (and businesses within those entities) with different activities may have access to different markets, the principal (or most advantageous) market for the same asset or liability might be different for different entities (and businesses within those entities). Therefore, the principal (or most advantageous) market (and thus, market participants) shall be considered from the perspective of the entity, thereby allowing for differences between and among entities with different activities.

Market access is entity-specific, as is credit status (paragraph 42):

The fair value of a liability reflects the effect of non-performance risk. Non-performance risk includes, but may not be limited to, an entity's own credit risk (as defined in IFRS 7, 'financial instruments: disclosures'). Non-performance risk is assumed to be the same before and after the transfer of the liability.

From these paragraphs, it appears an exit price is essentially the price that another entity would require to step into the position of the selling entity with respect to the trades. By 'position', we refer to market access and credit status.

An exit price does not involve cancellation (paragraph 34), nor is it an entry price (paragraph 57 and appendix A).

IFRS 13 (paragraph 79) also covers the case where a liquid price in an active market does not represent fair value. This is particularly relevant for holding costs:

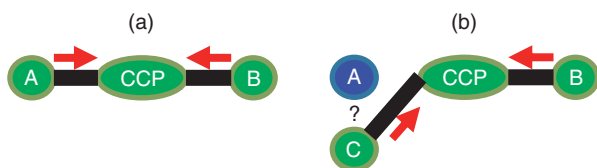
An entity shall not make an adjustment to a Level 1 input except in the following circumstances:

- (b) when a quoted price in an active market does not represent fair value at the measurement date.

IFRS 13 provides some detail about deciding on the aggregation of assets and/or liabilities in paragraphs 13 and 14. It refers to a 'unit of account', which is determined in accordance with the IFRS that requires or permits the use of fair value, with IFRS 13 being the ultimate override if there is a conflict. IFRS 9 does not refer to a unit of account, but it states in section 4.1.1 that the classification of financial assets depends on:

- (a) the entity's business model for managing the financial assets; and
- (b) the contractual cashflow characteristics of the financial asset.

1 Novation of trade through CCP



(a) Bank A enters an incremental IRS with bank B via a CCP. (b) Bank A novates the IRS to bank C for a sum '?'. Red arrows indicate the direction of IM postings. A does not know the net effect of the incremental IRS on IM requirements for B or C.

Thus, the entity's approach to managing derivatives is at least as important as the actual cashflow involved. The explanatory appendix B (sections B4.1.1 to B4.1.2B) states that several business models may coexist, depending on particular business objectives. It notes the business model is a factual construct, not a matter of intention, and a portfolio may be separated into sub-portfolios in order to reflect the management of those assets. Evidence of what the 'facts' are includes performance of the model, how risks are managed and the compensation of managers. Thus, the accounting takes its lead from how the bank is undertaking its management of derivatives.

■ **Application of accounting context to MVA.** Here, we consider the application of the accounting context to derivatives subject to IM in order to understand whether MVA should be part of fair value. We use examples to bring out the key considerations. The first example involves vanilla IRSs traded by banks through a CCP (figure 1). The second example is a hedging package (figure 2), ie, an IRS traded with a client and market risk-hedged with the street, ie, using an opposite IRS traded with another bank through a CCP.

EXAMPLE 1 Bank A enters into a vanilla IRS with bank B; both banks are clearing members of a CCP and have similar market power (ie, bank A cannot set the swap price arbitrarily via a direct fee from B separate from the CCP pricing). Since the IRS is vanilla, and both bank A and bank B are clearing members of a CCP, the IRS is intermediated by the CCP. Considering bank A, the CA that bank A has signed specifies that IM must be posted by bank A. The CA also defines what collateral bank A must post if out-of-the-money (VM) as well as the collateral rate on this collateral (and vice versa).

What fair value should bank A reflect in its accounts from entering the IRS through the CCP? We answer this question in a situation (1) where the IRS is accounted for without the IM 'standalone only' and (2) where the IRS is accounted for together with its IM 'standalone: all effects'. We will consider this transaction from several points of view for clarity. First, we use a straw-man proposal with a single incremental IRS traded by bank A, which increases its IM requirements with the CCP. Similar arguments also apply for a new IRS that decreases its IM posting, because this means there was a pre-existing position, and for that position to be rational (ie, not lose money) the pre-existing position must have been a hedging package (see example 2 for a hedging package).

■ **Straw-man proposal: standalone only.** Here, we assume the effects of the IRS transaction will be accounted for on the transaction date, and

at future dates, according to the VM collateral calls on the trade by the CCP. That is, the effects of the IRS are only considered as the valuation the CCP puts on the IRS alone, as demonstrated by VM calls (or the part of such calls that is (gross) attributable to the IRS).

■ Let us assume for this straw-man proposal that bank A accounts for this standalone IRS, with the standalone price given by the CCP, on the grounds that bank A assumes it can exit the trade at any time by paying the current standalone price to bank B.

■ We further assume that since the IRS effects are accounted for as the standalone price from the CCP, bank A argues the MVA costs from the CCP IM requirements as contractually required in the CA are accounted for as zero. That is, in this straw-man proposal, no MVA costs are present in accounts as a consequence of entering into the IRS. Only the standalone IRS is reflected in accounts and at the CCP price (VM price).

The above is labelled a straw-man proposal because it clearly fails many basic tests, as we shall now describe.

■ **Exit price, novation.** Consider the wording of IFRS 13: 'the price that would be received to sell an asset or paid to transfer a liability'. In IFRS 13, this price is explicitly not the entry price. If bank A transfers (novates) the IRS to another bank, C (figure 1(b)), then bank C will face the incremental cost of posting IM (possibly positive or negative, depending on its existing profile) and will require bank A to make it at least flat in order to be indifferent to whether the transaction is performed or not. Given that posting IM to the CCP is a contractual certainty, this other bank, a typical market participant (in IFRS 13 terms), will require compensation for any (positive) incremental costs of posting IM. If not, then bank C is not acting in its economic best interests.

Given that bank A does not know what the profile of bank C will be if it attempts to novate, or what information bank C will have on bank A's profile, how should bank A account for MVA? The entity-specific parts of IFRS 13 offer a guide, ie, a bank should consider its own status (its pre-existing profile, because other market participants would also consider their own profiles) and use that. Thus, bank A should use its own incremental MVA in accounts for the trade.

Bank A cannot argue that bank C will have different funding costs because IFRS 13 requires the entity-specific assumptions of similar market access and similar credit status, and hence funding costs.

Bank A cannot argue that it will wait until a win-win situation occurs with bank C, whereby both their incremental MVA costs are negative for the transaction, because IFRS 13 explicitly classes the bank's intentions to sell or hold as irrelevant (paragraph 13).

■ **Exit price, cancellation.** Can bank A cancel the trade with bank B at the CCP price for the trade? Cancellation may be possible, but does this also mean the cashflow due to other contracts – ie, the CA and the arrangements (costs) for obtaining the collateral to post for IMs – can be ignored prior to cancellation? Market practice is not to ignore the cashflow from other similar contracts, ie, CSAs. Thus, it appears difficult to argue for disregarding contractually agreed cashflow.

As quoted above, IFRS 13 specifically ignores the bank's own intentions in pricing. If bank A argues that it is just about to cancel the trade and hence should ignore future contractual cashflow related to the trade, then this appears to fail the requirement to ignore intentions.

■ **True and fair.** Suppose bank A is aware it does post IM on the IRS and that the unsecured funding costs of the IM are not zero. Does setting the

unsecured funding costs to zero in accounts provide a true-and-fair picture of its financial position, as required under the Companies Act 2006? This does not appear to be the case. The International Accounting Standards Board's conceptual framework of accounting (IASB 2010) states that two fundamental qualities are required for true-and-fair accounting: relevance and faithful representation. IM is relevant, as it is an essential part of the derivatives transaction and thus needs to be included in a faithful representation for accounting terms. The related accounting standards (IFRS 13 and IFRS 9) are the technical toolkits to achieve that faithful representation.

■ **Rationality: IM (MVA).** An incremental standalone IRS at a CCP will generate increased IM requirements by assumption. This IM must be funded, unsecured, for the life of the trade. If unsecured funding is not free, then this incremental standalone trade is expected to lose money because of IM. A standalone IRS can be part of a proprietary trading strategy that, by definition, is not assessed in risk-neutral terms because it is not fully hedged. That is, it takes risks to make profits. If it is not a part of proprietary trading and is considered standalone, how is a standalone trade rational considering increased MVA? If we consider market participants to be acting in their best interests, then they will not enter this standalone trade at a standalone price.

■ **Rationality: capital (KVA).** A standalone IRS generates market risk for which capital must be held. If capital is not free, then this standalone trade will lose money unless it is part of a proprietary trading strategy. If it is not a part of proprietary trading and it is considered standalone, how is a standalone trade rational considering KVA? If we consider market participants to be acting in their best interests, then they will not enter this standalone trade at a standalone price.

Given the difficulties of the standalone-only position, let us consider an extension of this position, which we call standalone all effects.

■ **Standalone all effects.** In this case, all economic effects of the standalone IRS are accounted for. Specifically:

- IRS valuation at VM level, according to the explicit contract with the CCP;
- the cost of the explicit contract between bank A and the CCP, requiring bank A to post IM for the market risk of the open position with the CCP; and
- the cost of the implicit contract between bank A and the regulator, requiring bank A to hold capital for the open market risk of the IRS, as evidenced by the fact that bank A holds a banking licence from the regulator.

Note the contract between bank A and the CCP specifies that the CCP is the valuation agent; it details in general how the CCP will value the trade. At present, this valuation is usually based on the collateral definition and interest rate paid on the collateral (also known as VM). Part of this same contract with the CCP specifies the level of IM that bank A must post.

The standalone all effects setup resolves the true-and-fair issues by reflecting the actual economic position with respect to MVA and KVA costs from explicit and implicit contracts (IM and regulatory capital). However, the standalone all effects still fails the feasibility test for US banks because it appears to be a proprietary position. Standalone all effects also fails the rationality test for non-US banks (for those IRS trades that are not doing proprietary trading) as there is an expectation of losing money.

Since US banks are forbidden under Dodd-Frank to engage in proprietary trading, we now consider the IRS trade as part of a hedging package, ie, not part of proprietary trading specifically, but rather client servicing. We analyse two treatments: no effects and all effects. No effects is where

2 Hedging package (CCP + client) example



Bank A trades an IRS with client X and hedges with bank B via a CCP. From the considerations of example 1, we expect bank B to also be hedged with client Y. Both clients are too small to be subject to BCBS-317.

IM costs and capital costs are accounted at zero. All effects includes IM costs and capital costs in fair value.

EXAMPLE 2 (Hedging package CCP + client) Here, bank A has two IRS contracts: one with the CCP and one (in the opposite direction) with a collateralised client with whom there is no requirement for bilateral IM. Let us suppose the fixed rates on both swaps are of sufficient similarity that the pair of trades drops out of the market risk capital framework. Thus, economically, there is only the valuation of the two IRSs and the IM cost over the lifetime of the trade with the CCP, as required by the CA.

■ **Straw-man proposal: standalone only.** Suppose bank A accounts for the hedging package as the valuation of the two IRSs, each as standalone only. The economic effect of the lifetime cost of IM (MVA) is not accounted for. From our previous analysis, we have the following:

■ **Exit price, novation.** It would be unusual (but not impossible) to novate the trade with the client to another client. The previous arguments can be applied for each of the trades in the package. Hence, MVA costs would be priced into any novation of the trade with IM requirements to another market participant, as it would also face those costs dealing through a CCP.

■ **Exit price, cancellation.** If bank A cancels the CCP trade, it must immediately put on an equivalent trade in order not to pay market risk capital costs for the then-unhedged trade with the client. Whether or not this new trade is subject to IM requirements, the previous arguments that the cashflow is due to the CAs with the CCP still hold.

The same arguments apply to cancelling the client trade. IFRS 13 forbids arguments based on intention.

■ **True and fair.** Not including the economic cost of the explicit contract with the CCP, which requires bank A to post IM whenever it has a net position, appears to fail this test. The test in question is an economic one that is part of the Companies Act 2006. Whether or not market participants are including the cost of IM in their valuation is irrelevant from the point of view of true and fair. If leaving out the economic costs of IM does not provide a true-and-fair view of the company's economic position, then auditors are required to take notice so long as it is material (Companies Act 2006, section 393, part 2).

■ **Feasibility.** Supposing the fixed rates on the two swaps are such that the economic benefit of the package is less than the cost of the IM at the CPP over the lifetime of the swaps, will this package ever be done? The answer is quite possibly, given the relationship with the client may encompass non-derivatives and the client relationship may be evaluated on a long-term basis over many types of activity.

Suppose, alternatively, that the spreads on the IRS are such that the economic benefit of the trade to bank A is greater than the cost of IM at the CCP over the lifetime of the trade. The package is obviously feasible in this case.

■ **Standalone all effects.** In this case, bank A reflects into accounts the value of each IRS from a standalone point of view. It also includes the cost of IM (MVA) required by the CA with the CCP over the life of the package. Capital costs (KVA) are also included. How does this look from the point of view of our previous analyses?

■ **Exit price.** Arguments above from both novation and cancellation are respected by including costs from all explicit and implicit contracts and ignoring any entity-specific intentions. (The implicit contract is the regulatory requirement to hold capital.)

■ **True and fair.** Since all of the economic effects are now reflected in the financial position of the company (according to its accounts), there is no objection from this point of view.

■ **Feasibility.** The previous analysis holds: even if the package including MVA loses money, this may be done as part of a client relationship over many different transaction types considering the expected lifetime of the client relationship. This perspective does not change valuation requirements.

The estimated cost of bilateral IM for trading through a CCP is roughly one basis point per 10 years of maturity (Sherif 2016; Green & Kenyon 2015). Bilateral IM using Simm may be higher, as Simm is calibrated to twice the margin period of risk of a CCP (10 days), and to ‘a significant period of market stress’. This can be compared with a typical bid-ask spread in an IRS trading of 0.25 basis points (Sherif 2016b). MVA thus appears to be material, so it cannot be ignored as it is not material.

■ **Derivatives accounting summary.** From the point of view of IFRS 13 (‘fair value’), IFRS 9 (‘financial instruments’) and the Companies Act 2006 (especially section 393, ‘true and fair’), the two appropriate accounting treatments appear to be:

- standalone all effects, and
- hedging package all effects.

The first treatment is appropriate for proprietary trading, while the second is suitable for package, or net, positions. Leaving out economic effects appears to fail both the exit price criteria in IFRS 13 and the true-and-fair test.

Market standard derivatives pricing combines the CSA with the term sheet of the transaction, ie, including non-term sheet contracts in pricing is not new. Hence, it is consistent with current market practice with respect to economic effects to include CSDs and CAs between CCPs and their clearing member banks where these cause economic effects (cashflow). While it is market practice to price CSAs into individual derivatives, this is for convenience and not a necessity. Derivatives can be priced without taking into account the CSA, ie, uncollateralised, and the cashflow of the CSA contract on derivatives can be priced separately.

The list of economic effects above is essentially the exit price for both the transactions (trades) and the CSAs, CSDs and CAs combined. That is, if an alternative bank were to step in to replace bank A, then this alternative bank would face these economic effects. Thus, assuming the alternate bank was acting in its best interests, it would require compensation at the level of the sum of the economic effects in order to be indifferent as to whether it stepped in or not. In non-performance risk, we include both own-credit risk and effects of own-credit risk on the funding level of bank A. The use of own funding costs reflects the requirement to use own-credit risk before and after the transaction to exit the position (IFRS 13, paragraph 42).

■ **Accounting treatment.** We propose employing a similar accounting treatment for MVA to that used for KVA in Kenyon & Kenyon (2016).

A. MVA cost reporting location and implied unit of account

MVA cost reporting location	Implied unit of account	Implied pricing location
Part of trade requiring IM	Trade	IM-requiring trade
Part of trade that is hedged by a trade requiring IM	Trade	Hedged trade
In trade + hedge package	Package	Either hedged trade or hedging trade
Follow the economics of dealing with each counterparty requiring hedging where there is IM either on hedge, or both on hedge and with counterparty	Sales transactions, direct counterparty charging	Charge to originating counterparty
Separate line item on balance sheet	Desk, central charging	Charge-back by attribution

We value the financial instrument (FI) using IFRS 13 fair value by including lifetime costs of posting collateral (MVA) in order to comply with IFRS 9 and IFRS 13. The valuation model will typically include the present value of cash inflows of interest as well as outflows to pay for collateral postings (see the valuation techniques in IFRS 13, particularly sections B10 (‘income approach’), B12 (‘present value techniques’) and following). Using a standard IRS model at the inception of the IRS would record a value of £0, so as to leave the value flat if the expected costs of IM collateral are exactly balanced by the cashflow from the terms of the trade and cashflow due to VM collateral. Subsequent changes in value will be reflected in movements in the profit-and-loss account as well as increases in value resulting in profits being registered, and vice versa (IFRS 9).

The key point is that the treatment avoids the possibility that spurious profits – ie, the value of the MVA included in the terms of the trade – are booked ignoring future costs. Spurious profits would be booked if the costs of MVA were compensated for by changing the term sheet of trades (to make them more profitable), but the costs of MVA were not represented in accounts. This is exactly the same issue that appears when dealing with KVA.

As an example of the appearance of spurious profits, consider a vanilla receive-fixed interest rate swap traded in such a way as to require posting of IM (recalculated every day). Now suppose the costs of this IM (MVA) are included in the trade terms by increasing the fixed rate to be received. If MVA is not included in accounting for this trade, it will appear spuriously profitable. The spurious profits are actually required to pay for the funding of IM posted over the lifetime of the trade.

Practical considerations

Here, we consider practical aspects of MVA accounting; specifically where to account for MVA and inputs to the price.

IFRS 13 suggests deriving the pricing unit of account (eg, trade, package, counterparty, etc) from the business model. This means that the accounting location can follow the business model. In other words, MVA costs can be accounted at the location where they are charged, eg, the counterparty (ie, not the hedge with IM, where the cost arises). Table A gives alternatives.

In the accounting context section earlier, we saw that accounting does not require the law of one price to hold; the law of one price has been in retreat since funding value adjustment (FVA) became generally

recognised. Rather, IFRS 13 permits entity-specific considerations, provided they are treated as market participants would treat them. Explicit examples include market access and own-credit status. This suggests pricing MVA in the same entity-specific manner, using approaches that other market participants would typically use. That is, firms use their own funding information (as in FVA) as the input to MVA.

Conclusions

IFRS 13 ('fair value'), the Conceptual Framework for Financial Reporting (IASB 2010) and the Companies Act 2006 support the conclusion that the lifetime cost of IM (MVA), when required by CCPs or other regulations (eg, BCBS-317), is part of accounting fair value. This conclusion follows

from the economic effects of contracts (CSD and CA contracts) that cause the posting of IM and hence its costs. ■

Richard Kenyon is a senior lecturer at Birmingham City University and Chris Kenyon is head of XVA quantitative research at Lloyds Banking Group. The authors would like to thank both anonymous referees for materially improving the clarity and focus of the paper. The views expressed in this article are the personal views of the authors and do not necessarily reflect those of their affiliated institutions. They are the product of personal and independent research. Not guaranteed fit for any purpose. Use at your own risk.

Email: Richard.Kenyon@bcu.ac.uk,
Chris.Kenyon@yahoo.com.

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<i>Risk</i> August, pages 19–22</p> <p>Sherif N, 2016c
<i>Dealers wake up to MVA impact of new funding rules</i>
<i>Risk</i> August, page 6</p> |
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GUIDELINES FOR THE SUBMISSION OF TECHNICAL ARTICLES

Risk.net welcomes the submission of technical articles on topics relevant to our readership. Core areas include market and credit risk measurement and management, the pricing and hedging of derivatives and/or structured securities, the theoretical modelling of markets and portfolios, and the modelling of energy and commodity markets. This list is not exhaustive.

The most important publication criteria are originality, exclusivity and relevance. Given that *Risk.net* technical articles are shorter than those in dedicated academic journals, clarity of exposition is another yardstick for publication. Once received by the quant

finance editor and his team, submissions are logged and checked against these criteria. Articles that fail to meet the criteria are rejected at this stage.

Articles are then sent to one or more anonymous referees for peer review. Our referees are drawn from the research groups, risk management departments and trading desks of major financial institutions, in addition to academia. Many have already published articles in *Risk.net*. Authors should allow four to eight weeks for the refereeing process. Depending on the feedback from referees, the author may attempt to revise the manuscript. Based on this process, the quant

finance editor makes a decision to reject or accept the submitted article. His decision is final.

Submissions should be sent to the technical team (technical@incisivemedia.com).

PDF is the preferred format. We will need the $\LaTeX$ code, including the BBL file, and charts in EPS or XLS format. Word files are also accepted.

The maximum recommended length for articles is 4,500 words, with some allowance for charts and formulas. We reserve the right to cut accepted articles to satisfy production considerations.