

Implementing Hedge Accounting

Finding a way through the rules

Wednesday 16th March 2005

IAS 39 Financial Instruments – Recognition & Measurement

- Objective simple
 - Report derivatives at market value
 - Eliminate asymmetric accounting

- Result complex
 - Hedge accounting rules not designed for banking
 - Hedge accounting to offset new volatility

IAS 39 – Business response?

How much new volatility have I got?

What can I do to mitigate it?

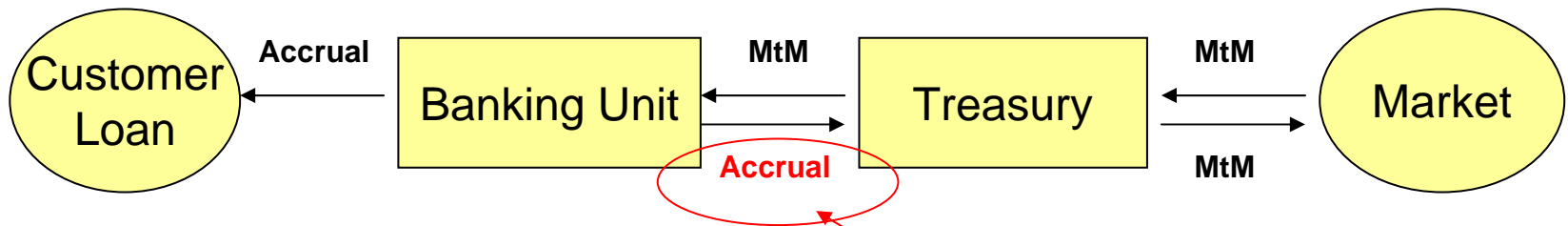
Do I change my business model?

ISSUE

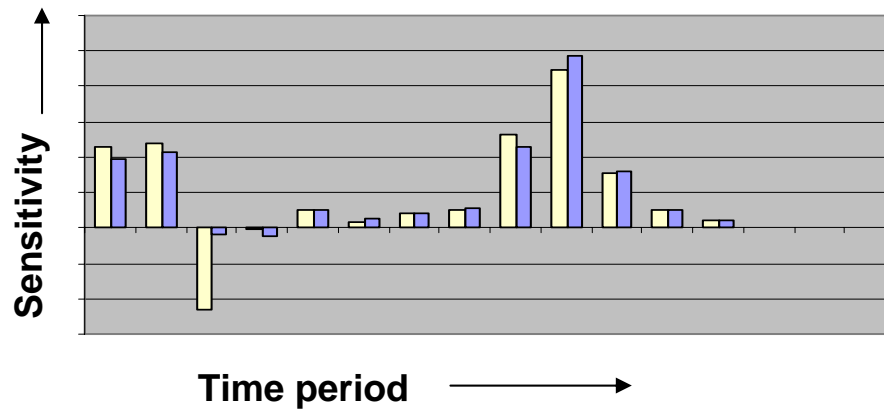
New volatility arises from something not generally measured

Sizing the problem

- Risk is transferred around a group with derivatives



- Create a term structure of sensitivities



Additional volatility profile is the sensitivity of these derivatives

- Micro-hedge complex risks
- Calculate a Value at Risk ...and reduce it

What tools are available?

Fair Value Hedge

- Select existing assets and mark to market through P&L

IMPACT

- Volatility offset in P&L
- Carrying value of assets adjusted

Cash Flow Hedge

- Select derivatives to mark to market through reserves

IMPACT

- Volatility removed from P&L
- Creates volatility in reserves

Decide what to tackle

- What is the appetite for earnings volatility?
- What is the appetite for reserves volatility?
- What instruments can you use?
- Where is the risk?

Main company only?

What level in the organisation?

Management accounting?

Local reporting?

Choice depends on characteristics of your business

...and on the rules

General Rules

- Designate and document
 - Hedging instrument *and* hedged item
- Expect hedge to be highly effective
 - Requires “prospective” hedge effectiveness testing
- Must have been effective during period
 - Requires “retrospective” testing

Rules that bite – cash flow

Rule

- Hedge exposure to *variability* in cash flow
- Transactions must be highly probable
- History of de-designation challenges predictions

Consequence

- Cannot swap fixed to floating
- Tests the forecasting or planning horizon
- Limits maturity of hedge derivatives
- Hedge needs to be reasonably static

Rules that bite – Fair Value

Hedged item

Rule

- Assets in hedge must be “similar”
- Can designate risks to hedge
- Dynamic hedging allowed

Consequence

- Large number of hedges
- Partial rate or partial term
- Regular re-balance or de-designate

Rules that bite – Fair Value

Hedge instrument

Rule

- Can use proportion of hedge but not part of hedge
- Must be effective for the life of the instrument
- Can mix derivatives in hedge relationship

Consequence

- Cannot designate “first 5 years”
- Hedge cannot be longer than hedged risk
- Spread swaps around to get good hedge fit

Hedge effectiveness

... to achieve hedge accounting

- 80/125 test
- Correlation tests
- Sample size
- Dynamic hedging

... to achieve desired result

- Select assets for FV
- Select derivatives for CF
- Consider micro-hedge option
- Think about the VaR

Remember what you are trying to achieve

Documentation

- Requirement to document hedges is fundamental
 - Hedge objective
 - Hedged item
 - Hedging instrument
 - Effectiveness testing

- Sarbanes-Oxley (US registrants only)
 - Hedge accounting is optional
 - If hedge accounting is not likely to be material, why do it?
 - If you do it, it is likely to be in scope

Understanding

- Subject matter is complex
 - Rules *not* intuitive
 - What is it trying to achieve?



- Need to know how it is working
 - Risk management tools
 - Attribution

Conclusion

- Hedge accounting:
 - Is optional
 - Can be complex
 - May be burdensome
 - Does not change a single cash flow

Don't do more than you need

Whatever you do...

Understand it

Prepare the market

