Towards transparency

The debate over the impact that IAS 39 *Financial Instruments: Recognition and Measurement* will have has been raging for several years and it will continue right up to its final implementation in April 2006. There is no doubt the standard is considered complicated to implement and that many treasurers and chief financial officers have viewed the measures it will impose as an additional complication that they will have to overcome if they are to be able to manage their financial market risk effectively and efficiently.

However, as the standard's full implementation nears, the question now to ask is whether IAS 39 will make that much difference to the way treasurers manage the foreign exchange (FX) exposure they have that arises from their companies' commercial activities. Specifically, the issue is whether or not IAS 39 will curb the use of currency options. The conclusion is that it will not.

IAS 39 may eventually prove to be an accounting equivalent of the Y2K issue. Europe's 7,000 listed companies will spend a fortune getting ready for it, because the standard contains extremely detailed rules and regulations that will have to be met if they want to comply.

Initially, some companies will probably feel that the effort is not worth it and resort to using simplified means of 'hedging' their financial exposure, such as spot, forwards and in combination outrights. Ultimately, though, more forward-thinking corporate treasurers will soon resort to using options once more or even for the first time. They will realise that even if there are accounting issues that need to be addressed, these can be surmounted, and that using FX options in most cases is the most effective tool to use in order to manage risk.

Options can be used to prevent or reduce exposure to adverse currency moves while still providing upside 'profit' potential in a way that using traditional cash instruments simply cannot. FX options enable corporate treasurers to tailor specific solutions, offering a complete protection against unfavourable market fluctuations, while enabling gains from beneficial moves. These can be transacted with minimal or no costs.

The experience of companies in the US and their compliance with FAS 133 *Accounting for Derivative Instruments and Hedging Activities*, which can be thought of as broadly analogous to IAS 39, provides the evidence to support the view that option use by corporates will grow. There is no doubt that FAS 133 did at one time cause many treasurers to refrain from using options, but that has proved to be a short-term phenomenon.

We are now directly witnessing a greater appetite by US corporations to use derivatives generally, and options more specifically. Corporate treasurers are now more easily able to convince their boards that using options is the most sensible way of managing financial risk. What FAS 133 has brought about is a framework that makes boards far more prepared to sanction their use, because they feel that an important safety net has been placed under them.

And this is why IAS 39 should be welcomed. There is no doubt that IAS 39 is well intentioned, even if some believe that it is difficult to implement. But at the heart of the regulation is the requirement that organisations look carefully at their exposure to all financial instruments and make sure that they are properly revalued.

UDI SELA SETS OUT HOW TO MANAGE FOREIGN EXCHANGE EXPOSURE IN THE POST-IAS 39 WORLD – SITUATIONS WHERE THE CURRENT VERSION OF THE STANDARD COULD RESULT IN ECONOMIC DISTORTIONS.

Executive summary

- IAS 39 *Financial Instruments: Recognition and Measurement* should not curb the use of currency options.
- Accounting issues can be surmounted and FX options are an effective tool to manage risk.
- As past derivative catastrophes have shown, many corporations have lacked the technology and knowledge to revalue their option positions properly.
- If an organisation relies on Black-Scholes, there is a real risk that a sudden loss will materialise.

To comply with the standards, organisations will have to separate their pure hedging activity from financial activity that has a more speculative nature. If positions do not qualify as hedges, which will not be easy, they will have to be marked on the balance sheet and in the profit and loss account. This should prevent some of the speculative activity of the type we have seen in the past, which has often ended in disaster.

But while IAS 39 will provide a framework that supports those companies that want to manage their FX exposure in the most efficient manner, the difficulties that compliance brings should not be played down. According to PricewaterhouseCoopers: "The underlying premise of hedging within IAS 39 is that cashflows on the hedging instrument and the hedged item should match exactly in timing, quantum and currency if a hedge relationship is to be effective from an accounting perspective. There is little allowance for a 'best fit' hedging solution."

This has many interpretations. Using forwards and outrights is an obvious solution, as they are transparent and simple to value. So even if trades are done to specific dates, the value of the outstanding position is easily calculated. Exchange-traded options are likely to provide only a best-fit solution, because of the rigidity of contract size and maturity. Over-the-counter options are undoubtedly the best hedging instrument, but the obvious problem is how to revalue them accurately at fair value, as IAS 39 demands.

The most effective FX strategies are bespoke structures that are designed and executed in the over-the-counter market. Prices for these are not published as a matter of course on screens, so revaluation is obviously more difficult. As past derivative catastrophes have shown, many corporations have lacked the technology and knowledge to revalue their option positions properly. Over-reliance on auditors to do this for them has not always proved the answer; for the auditors themselves, recent scandals will ensure that they err on the side of caution in efforts to ensure that another Enron-type scandal does not materialise.

The main issue, and it will remain the major factor even after all the other technical problems surrounding IAS 39 are resolved, is that options can be hard to revalue using many systems. Reliance on the venerable Black-Scholes model or those derived from it, does not supply a fair market price revaluation.

For anything except pricing at-the-money (ATM) vanilla options, Black-Scholes is often totally inaccurate. If an organisation relies on Black-Scholes, there is a real risk that a sudden loss will materialise. The root of the well-documented FX option scandal at National Australia Bank was that traders were able to manipulate their revaluations using Black-Scholes instead of revaluing at real market values. In short, they manipulated the difference between the inaccurate Black-Scholes theoretical value and the true market price (fair value) of options to finance their initial trading losses.

Another flaw concerns the input data, such as implied volatility, required to produce an option's supposed value. In the Black-Scholes world, the only input, other than spot and forward rates, is ATM volatilities. These are available on screens, but using the Black-Scholes approach is an extremely unsafe route of revaluation. Ask any option trading or risk management professional and they will tell you that Black-Scholes seldom delivers the fair market price. Not surprisingly, this has been recognised, which is why IAS 39 requires revaluation with fair market prices (*see Figure 1*).

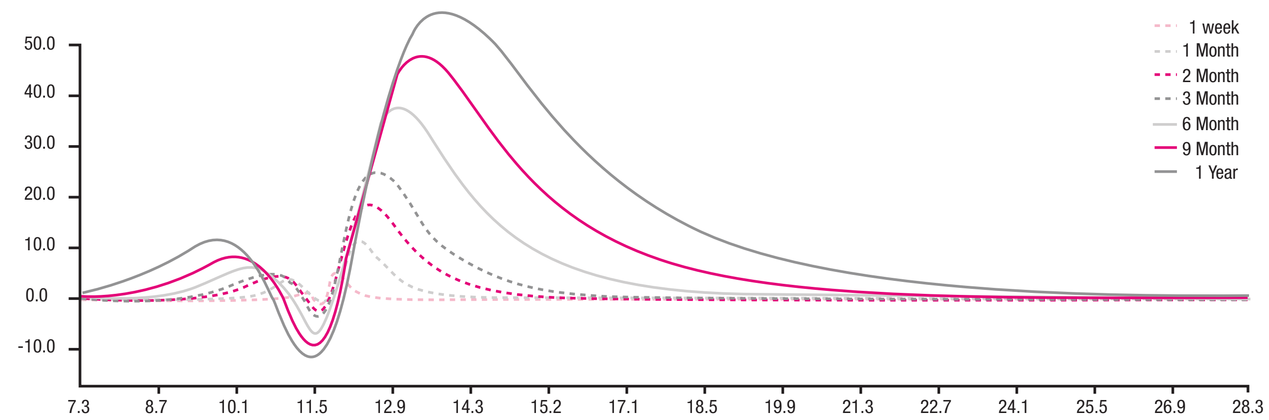
This is the requirement that has caused the biggest problem for many corporate treasurers. Until recently, there was only really one way that corporations could comply with the regulation, and that was to ask their banks to revalue their portfolios for them.

Clearly this is far from ideal. Sell-side institutions are not always happy to do this, as it requires time and effort and they also run the risk of damage to their reputation if they inadvertently pass on an inaccurate rate. If they do it deliberately, they run the risk of being sued and then fined by the regulators.

This situation started to change when companies like mine introduced transparency into the market around 2001. Now the true market price for any option on any currency is readily available on a screen. This enables corporations and their auditors to revalue derivative portfolios independently with the fair market price.

Also, as components of IAS 39 have been adopted over the last three years, corporations have had time to adapt and change the way

Figure 1. Market prices for one-year sterling/rand options are nearly 60bp away from Black-Scholes revaluation



Source: SuperDerivatives

they perform their derivative revaluations. The need to comply with the regulation has helped corporations to improve their understanding of their financial needs.

The fact that financial hedging transactions are largely attached to cashflows has made treasurers analyse the efficiency of these trades. Also, the growing understanding of the difference between the hedging component and a financing or speculative component has dramatically improved the hedging strategies of corporations.

As an example, around five years ago many corporations were actively using knock-out options, which expire worthless when the option is in the money. In other words, the option expires when the hedging is critical. These options are relatively cheap but because they were not always understood, corporations remained exposed to market fluctuations, often at the very moment their exposure was greatest. Under IAS 39, the use of such options is not considered as hedging.

However, treasurers have noticed that there are structures where combinations of options can be bought and sold with the result of creating effective hedging, which amounts to a drastically improved performance compared to an outright forward transaction. In this case, they can argue that the whole transaction should be considered as a hedge.

A classic example of this type of structure is the 'forward extra'. Here, the corporation buys a vanilla option and sells a reverse knock-in option with the same strike. The corporation has no liability if the trigger remains untouched and can execute the FX transaction at a favourable prevailing rate to the outright forward. If the trigger is touched, the structure becomes a regular outright forward. There are numerous such strategies that provide extremely useful and flexible tools to reduce risk.

Many corporations in the US, including those that previously did not use options, have already grasped the fact that options are the best hedging tool since they can be tailored exactly to meet their FX exposure. What they have realised is that they have to have in place a good system or mechanism to revalue their derivative financial portfolios. Once they have that, they are far more comfortable than ever before in using options. This scenario will also emerge in Europe.

There is now an accepted benchmark model for pricing options. If there were not, it would still be very difficult for corporations to comply with IAS 39. The fact that there is has real benefits for the corporate community. The option world is more transparent than it has ever been. It is not only easy to obtain accurate market prices for all options – which is crucial for revaluation – but they can access systems for pricing and risk managing options that are as good as those used by the most active banks' trading options. System vendors need to recognise that they have an important role to play in teaching corporations how to optimise their hedging. Part of this process is to deliver the products that meet their needs.

IAS 39 and the earlier FAS 133 have proved challenging for many. The standards have forced corporations to examine whether their existing systems are doing what they should, which is to price options accurately. The introduction of transparency into the world of options has many ongoing implications. Taken with the requirements of IAS 39, transparency will allow corporations to emerge from the 'dark age' of option pricing and into a new era. If they do not, they will mismanage their assets, which is no longer acceptable or justified.

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