Tectonic changes

JOHANN KRUGER LOOKS AT THE CHANGES AHEAD IN ACCOUNTING, FINANCIAL MARKETS REGULATIONS AND CORPORATE HEDGING BEHAVIOUR.

A wave of tectonic changes is about to hit the financial markets through 2014. Although some view most of these changes as predominantly affecting financial institutions, the reality is that every single participant of the markets, including corporate hedgers, will be affected.

ACCOUNTING IFRS 9 is the replacement standard for the controversial IAS 39. One of its main objectives is to align accounting for financial instruments and hedging more closely with corporate hedging practice. The hedge accounting exposure draft (ED) was published in December 2010 and the comments period closed on 9 March 2011. The IASB estimates that a final standard will be published in the second half of 2011 and early adoption will be allowed. However, there are a number of issues with the ED and, assuming these are ironed out, the remaining obstacle for corporates will be endorsement by the EU.

Endorsement typically takes a few months at most. But in the case of financial instruments accounting the endorsement process is particularly tricky because of the phased approach to IAS 39 replacement. IAS 39 is the only standard not fully endorsed by the EU. It is subject to carve-outs (the EU literally drew a line through some of the standard's text and endorsed the rest) in relation to portfolio hedging of interest rate risk.

Officially there are three phases of the IAS 39 replacement project, almost all of which are expected to be completed during the second half of 2011. However, portfolio hedging of interest rate risk, the second part of the hedge accounting phase, is likely to delay proceedings. It is one of the most controversial aspects of IAS 39. Drafting, exposing and finalising the wording is likely to be hotly debated and could take us well into 2012 before being finalised. Yet its completion is critical in securing the backing of the EU for the new standard. It would be in the interests of all entities in the EU if the corporate hedging part of the standard were endorsed largely as is during 2011, but there is currently no indication that the EU would be willing to yield on this point.

Of course, entities outside the EU are free to apply all International Financial Reporting Standards (IFRS) as they are published. But for entities that want to claim compliance with EU-endorsed IFRS there may be a long wait before the shackles of IAS 39 can finally be cast aside. In the UK, most unlisted companies currently applying UK Generally Accepted Accounting Principles (GAAP) will have to move to IFRS from 2013. This will require a significant change and endorsement could become critical for them, otherwise they will

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be faced by changes first to IAS 39 and then to IFRS 9.

In relation to the current wording of the ED, a number of fundamental issues are to be addressed. Some are discussed below.

One of the general requirements for achieving hedge accounting is that a hedge must produce an "unbiased" result and "minimise expected hedge ineffectiveness". Along with the requirement to rebalance the hedge (should the first objective not be met) and the prohibition on voluntary dedesignation, the requirements could be interpreted as being far more restrictive than IAS 39. This is clearly unintentional. The term "unbiased" is new to IFRS and needs clarification or replacement. In addition, using the words "reasonably effective" in relation to expected effectiveness (the words appearing in the US GAAP ED), would be consistent with reflecting common, sensible risk management practice and remove the potential ultra-strict interpretation of hedge effectiveness requirements. Mandatory rebalancing implies a very high operational burden. Since the degree of precision of hedges varies with each corporate, rebalancing should be voluntary. Since all ineffectiveness must be recognised in the income statement, systematic abuse of the qualification requirements is unlikely to yield much reporting benefit.

The ED limits hedge accounting to exposures affecting the income statement. However, certain exposures affect Other Comprehensive Income (OCI), a reserve account, and in practice there are valid reasons for hedging them. For example, the FX risk of strategic equity investments recorded at fair value through OCI and risks inherent in defined benefit pension schemes would not (under current pension accounting proposals) affect the income statement, yet risk management of these exposures is perfectly valid and sensible.

The required disclosure of forecast hedged exposures presents two problems. First, it distinguishes between hedged and unhedged exposures, the latter requiring no disclosure. This could discourage hedges of commercially sensitive exposures to avoid disclosure. Second, it may not be appropriate for management to disclose or for auditors to opine on such forward-looking information in the annual report.

The transition requirements are by no means clear. The International Accounting Standards Board (IASB) needs to clarify how to deal with existing hedges when current designations are not in line with the new standard, especially where part of a hedging instrument that was outside of the designation in the past is best included from conversion date.

The basis for effectiveness testing is a comparison of fair values of instruments. Yet most corporate hedging practices focus on fixing cashflows. For this type of hedge all a corporate is really interested in is matching cashflows with the floating leg of a swap and getting the best possible price for the fixed side. It is unclear whether IFRS 9 will allow an effectiveness test that reflects this risk management practice.

There are many more issues with the detailed wording in the ED. The IASB needs to consider the feedback, iron out unintended consequences and focus on simple, practical solutions to remaining issues.

THROUGH A CONFLUENCE OF TIGHTER REGULATIONS IN ONE AREA (BASEL III) AND A RELAXATION IN ANOTHER AREA (IFRS 9), THE POPULARITY OF OPTIONALITY IN HEDGING INSTRUMENTS MAY WELL RISE.

DERIVATIVES ON EXCHANGE Between the US Dodd-Frank regulations (implementation by July 2011) and the EU equivalent (implementation by December 2012) corporate end-users are close to having won an exemption from central clearing. Some issues remain, such as the definition of what constitutes commercial hedging activities; what happens to non-financial entities that have both trading and hedging activities; and the political risk arising from the EU parliament vote on the legislation. However, a chorus of corporate voices successfully argued for the retention of the status quo for a market that has been functioning very well for them – even throughout the financial crisis – for at least three decades.

BASEL III Capital requirements for banks are calculated using the following general formula:

(a) assets x (b) risk weightings x (c) capital percentage charge

Regulators are in agreement that banks must hold more capital against their assets. Basel III proposals would increase the general requirements, first by defining core Tier 1 capital more strictly (affects (c)); second, by increasing the percentage of capital to be held against risk-weighted assets (RWAs, defined as (a) x (b)); and third, by changing the RWA calculations for certain asset types it considers very risky. Uncollateralised over-the-counter (OTC) derivatives have been identified as such assets and a particularly penal additional asset weight is being proposed. The standard formula for calculation of this additional charge is most sensitive to the credit quality of the counterparty and the current fair value of the exposure to the bank (i.e. where the corporate owes the bank). For instruments with larger potential future exposures, banks would need to set aside capital not only for the inception exposure, but also for expected credit exposures during the life of the trade. It follows that BBB-equivalent counterparties executing cross-currency swaps are likely to be severely impacted. The effect is multiplied for companies lower on the credit curve. However, even higher-quality counterparties are likely to see a not insignificant increase (at least a doubling) in the cost of transacting cross-currency swaps in particular.

Although collateralising these trades would remove the cost, the extra liquidity risk could be terminal. In the 1990s German company Metallgesellschaft folded because of the cashflow volatility of its futures hedging programme. The consideration of whether or not to clear centrally is not simply a comparison between the cost of a credit line to cover potential collateral calls versus the additional credit charge on an uncleared OTC trade. The cashflow volatility from having to post margin, which will consist of both initial margin (even for in-the-money trades), which can be between 5% and 20% of notional, and variation margin (to cover current mark-to-market), will increase the risk associated with investing in the firm both for debt investors and equity investors. There is therefore a much broader impact on the economy in terms of corporates' cost of capital and unproductive cash.

The tightening of the definition of regulatory capital and increases in capital percentage charge are phased in between 2013 and 2019, along with other changes, such as additional liquidity and leverage limits. However, the RWA requirement for uncollateralised OTC derivatives, which is by far the largest portion of the change, will be introduced as a big bang on 1 January 2013.

There is a real possibility that all the efforts of corporates sharing their concerns with the EU regarding central clearing of derivatives could be undone by the capital requirements Basel III plans to impose on uncleared OTC derivatives. The increased cost of excessive capital requirements are likely to be passed on to customers. Basel III will be implemented by the EU as part of Capital Requirements Directive IV. Corporates as key economic actors of the real economy, have a powerful case to make to the Basel committee to defend their ability to operate in and manage the risks of the real economy.

Interestingly, through a confluence of tighter regulations in one area (Basel III) and a relaxation in another area (IFRS 9), the popularity of optionality in hedging instruments may well rise. This is because the accounting would no longer be an obstacle and purchased optionality clearly benefits the cost (because of the limits on banks' counterparty exposures) and cashflow volatility (because of the limited adverse fair value movements) from hedging activities. This would be a beneficial development for corporates, which have long appreciated the value of options as hedges yet found the accounting treatment dissuasive.

CHANGING LANDSCAPE In addition to the above regulatory changes, other changes to accounting standards (such as leasing, pensions, revenue recognition), the MiFID regulations and Solvency II (affecting insurance companies assets, with knock-on effects for funding for the real economy) will work together to change the hedging landscape beyond recognition. The next few years are likely to see many well-established and popular practices affected dramatically. Treasurers will need to remain aware of the latest changes and implications for their businesses. Failing to keep up with the incoming wave of changes will be costly.

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