The three laws of hedging

Hedging has, by definition, always been a risky business. FAS 133 has now made it a complex one, too. David Burns of Basell explains how his company is dealing with it.

There is no law which states that you must hedge. Legislators have seen fit to require company directors to do a number of things, such as appointing external auditors and filing financial accounts, but hedging the result is not yet one of them. One day shareholders might sue a director for negligence in failing to hedge; but at present, the director's safest course of action is probably to stay away from an activity where complexity breeds risk. Thus, many small companies (and some quite big ones, too) do not hedge.

Industry background

In the European petrochemicals industry, major hedgeable exposures are inevitable. Most companies have active hedging programmes. These multinational companies have costly assets, make substantial borrowings, and thrive (or more often just survive) on wafer-thin margins. Petrochemical cracker feedstock prices are dollar-denominated and intrinsically volatile; monomers (cracker output) are euro-denominated; whilst polyolefins – the next stage of transformation – are sold mainly in local currency.

European companies which are US-GAAP compliant are still relatively rare, even in this industry. There are the subsidiaries of US groups; those who have their own US listing; others may have opted for US-GAAP as part of their corporate communications strategy. They surely have one thing in common – they didn't bargain on FAS 133. Companies who have volunteered for US-GAAP in the full knowledge of what FAS 133 meant for them must be few and far between. The Elenac group has had a polyolefins business which is mainly concentrated in Europe, with the euro as functional currency; yet we have always been (with the exception of one or two specific issues) US-GAAP compliant. This is because, of our two shareholders, Shell has been reporting under US-GAAP for many years, whilst BASF is also in the process of becoming fully US-GAAP compliant, as a consequence of US listing in 2000.

> European treasurers are at a double disadvantage with US-GAAP. First, we aren't American; second, we aren't accountants

Company priorities

In the July/August edition of *The Treasurer,* I described the priorities and strategy of our treasury department. Shortly after start up in 1998, short of staff and determined to keep things simple, we analysed economic as well as accounting exposures and concluded that a forex hedging activity would not add value. We ceased such hedging with shareholders and on financial markets by mid-1998. (Natural hedging of course remained an option.) Interest rate hedging was seriously considered, but the theory prevailed that it would be least risky to incur all debt on a floating basis and leave it there. Commodity hedging for our business would have been by far the most interesting of the three, but we considered that European financial markets were not deep enough in the chemicals sector to sustain this. The effect of these three decisions is that we have been able to concentrate our scarce resources in other areas of risk management, such as credit risk and project financing.

David Burns

This does not mean that a petrochemicals company such as this can consider itself unaffected by the three types of hedgeable risk. Economic exposures may be fairly balanced, particularly in forex; but there has definitely been an accounting exposure to differences in exchange. We have not needed to stabilise earnings in order to stay within covenants or to deliver to stock markets; but the large-company process of committing to an earnings target through business plans communicated to corporate shareholders is just as effective in this respect. The choice, however, is between economic exposure management – doing what is best for the company's intrinsic economic position – and accounting exposure management – doing what is best for the company's published results. The balance will depend on each company's circumstances.

For GAAP-compliant groups closing their accounts at year-end, FAS 133 becomes mandatory in January 2001. By October 2000 our group will have completed a three-way US-GAAP compliant merger with two others to form a new group, Basell, which will be a world leader in polyolefins worldwide.

As I explained at the Association's conference in June, 'FAS 133: The Good The Bad and The Complex', we will have to implement the standard ahead of the pack, after a shortened accounting period. One of the three groups would be US GAAP-compliant reporting for the first time. Another of the three would change functional currency. The new group would need to manage systems incompatibilities, make new management appointments and so on. I could have added – had I known – that the markets would be in a febrile state. Given the pressures upon us, my colleagues and I have needed to be clear-headed about the standard, in a way which I would sum up in the three laws outlined below.

The first law

We European treasurers are at a double disadvantage with US-GAAP. First, we aren't American; second, we aren't accountants. *The first law of hedging is that very few people have fully understood this standard*. I told my own staff, none of them native English speakers, not even to try. It is in Advanced American English. If you do read it, it more or less hangs together, and it grows on you, but no-one knows quite what it all means and how it will work. If the objective of the standard was to render hedging more transparent, it has already failed.

The second law

My second law of hedging is that FAS 133 is about hegemony. It must be understood in its sociological context. There are powerful economic interests at stake. The banks have built up a strong business by convincing commercial and industrial companies that they can reduce risk and add value through hedging and derivative instruments. This is in partial conflict with the interests of the accountants whose business it is to construct meaningful financial information. With FAS 133, the accounting community has reasserted its hegemony over an important area of financial life – and US-GAAP corporates acquiesce. In this respect, the standard has already succeeded.

Banks and IT service providers are scrambling to demonstrate that they can still add value in the context of FAS 133. But this is a side-show. The first task of the corporate is to address the requirements of its external auditors in order to demonstrate compliance.

Our auditors – and this will surely be the case throughout the US-GAAP compliant world – have started off with a carefully tautological paragraph in their annual letter setting out the audit programme for the group.

The gist is that we must have done everything reasonable in order to ensure compliance with the standard. This means, to start with, that we must identify any of our commercial contracts which are derivative contracts according to the definitions of the standard, and also 'bifurcate' any contracts which contain embedded derivatives.

This doesn't perhaps sound too bad, but on further reflection it is a formidable task. Some of these contracts are many years old, and none of them were drafted with FAS 133 in mind. Of the previous 132 standards, which has required such a far-reaching overhaul of the company's commercial history? We can apply FAS 133 relatively easily to new contracts, but merely a list of the titles of existing contracts runs into hundreds of pages. So the debate turns around questions of materiality, of grouping contracts into generic types, and of the acceptability for audit purposes of sampling techniques.

Meanwhile, some parts of the company have devoted considerable time to rereading old contracts – only to conclude that we have nothing to report. Others have come up with contracts which include underlyings, net settlement and so on – but which are manifestly not the sort of contracts targeted by the standard: ones where the underlying itself is largely a private matter for the companies concerned.

We must also look at routine forward commodity contracts which are placed in order to lock in advantageous margin differentials. For many businesses – and this appears to be the approach of the standard – such basis or margin hedging might in principle be risky. But for a petrochemical company, operating the type of fixed assets which cannot easily be closed down in response to poor demand, the risk is largely illusory.

> Of the previous 132 standards, which has required such a far-reaching overhaul? We can apply FAS 133 easily to new contracts, but merely a list of the titles of existing contracts runs into hundreds of pages

Fortunately, such contracts are by their nature short-term and easy to monitor. Here, though, ultimately lies the irony of this standard: the draughtsmen have laboured to express a conceptual framework which applies to all industries and all operating conditions. They have produced a framework which may be truly applicable to none.

For treasury exposure management, a source of concern is the reluctance of the standard to countenance exposure management at group level. For many groups, the volatility of the result of a particular legal entity is of limited significance. The trend of business should be to do away with the bureaucratic burden of intra-group hedging, and yet this standard seems to be going the other way. Fortunately, it is comparatively easy to batten down the hatches. We are changing functional currency anyway; we will hedge less than before, and send most through the accounts without a hedging designation. What we need above all is time before we are confronted with the pitfalls of documentation and hedge effectiveness. The First Law also applies to external auditors, so though there are undoubtedly already people within the practice who understand the standard, they are not necessarily yet represented on the audit team. For them, like us, this is a game which we will have to play, but it will be much more fun to play it next year.

The third law

The third law of this formidable game was emphasised by several speakers at the Association's June conference: *it all depends upon the attitude to volatility of your board, shareholders and lenders*. If, as a profession, we are to avoid becoming pawns of more powerful forces on the chessboard, we must make our practical views heard so as to influence our stakeholders in the direction of an understanding of fundamental economic risks, and a relative tolerance of short-term volatility in financial results.

There has never been a law saying 'you must hedge'. But there is now a law saying that, if you must hedge, you must do it in an unfamiliar and possibly unpleasant way, or possibly more unpleasant consequences may befall you. ■

David Burns is Chief Internal Auditor of Basell Polyolefins and a member of the Association.