

Hedging IR risk under FAS 133-138

Hedgers hoping to get to grips quickly with the latest US derivatives accounting rules are in for a rough ride. Nilly Essaides of FAS133.com attempts to explain.

Anyone seeking to make sense of FAS 133's treatment of interest rate hedges is likely to embark on a frustrating journey. Not only is FAS 133 notoriously complex and difficult to understand, but there's no clear single framework or 'key word' that can broadly – yet accurately – explain the way the new US derivatives accounting rule affects hedges of interest rate risk.

Perhaps the only general statement one could make, notes Ira Kawaller, an independent consultant and member of the Financial Accounting Standards Board's (FASB) Derivatives Implementation Group (DIG) – the only economist, or non-accountant, on the team: "It's clearly harder and not clearly better."

Kawaller is intimately familiar with FAS 133's complexities. As a member of the DIG, the group of accountants and industry representatives appointed by the FASB to help interpret FAS 133, he has spent the past two years attempting to make sense of FAS 133 by providing practical implementation advice.

Indeed, anyone who has sat through FAS 133 seminars, or read the available literature, can clearly attest to the fact that a straightforward and holistic framework for describing FAS 133's effects on IR risk management is nowhere to be found.

That's not because the speakers or authors – this one included – are disorganised thinkers or unable to penetrate the Byzantine logic of FAS 133. Rather, it's because the statement approaches IR risk on a piecemeal basis: in describing the treatment of particular hedge instruments or strategies.

Simple truisms

Such strategy-specific analysis is not only highly technical – hence best secured from your company's auditors, since interpretations still vary – but also difficult to memorise.

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There are, however, a few general 'rules' that can help put FAS 133's treatment of IR hedges in perspective:

It's more flexible – the (only) good news is that FAS 133 increases IR hedge programme flexibility (as it does for foreign exchange and commodity hedges) by allowing fixed and floating rate interest rate exposures to be hedged at any time using any instrument. Before, companies could only hedge new debt issues.

If you don't qualify for the shortcut method, you're out of luck – the new



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wiggle room does not come free of charge. In most cases, unless your swap qualifies for the shortcut method, it will generate some – and sometimes significant – income statement volatility due to ineffectiveness.

The shortcut method allows hedgers to assume no ineffectiveness, provided that their hedge meets a list of rather strict and very specific criteria. While the DIG and the FASB have added some provisions that make the shortcut a more realistic solution, there are still tall hurdles companies must meet in order to qualify.

For example, off-market swaps are out. The swap must have a fair market value of zero at inception. The swap and exposure must match up, perfectly, in terms of duration, reset dates and the like. And some forms of prepayment, and any non-linear provisions, are likely to disqualify the hedge.

If a hedge does not fit within the shortcut parameters, then hedgers must account for their actions the 'long way', (that is, compare the fair value of the hedge to the exposure, measure the difference and record any ineffectiveness in current income). And there's likely to be some ineffectiveness to record (see box on page 44).

Synthetic accounting is out – perhaps the most painful effect of FAS 133 is that it does away with this process and anything that walks or looks like it.

Indeed, the urge to do away with synthetic accounting has been one of the motivating factors behind FAS 133's creation.

DIG issue G7 offers some measurement options that look a lot like synthetic accounting by allowing companies to design a 'perfect' hypothetical hedge and measure their real thing against it to identify any ineffectiveness (visit the FASB's website, www.fasb.org, for a complete write up on G7).

FAS 138 offers some relief

By far the most common request for FAS 133 amendment involved the definition of the risk-free rate. Under FAS 133, the market IR was defined as the risk-free rate, plus the appropriate credit sector spread.

This definition would have made it nearly impossible for companies to find a perfectly matched hedge instrument, since any liquid Libor or treasury-based instruments would not have covered the credit risk component of the underlying exposure. The difference would end up as ineffectiveness and result in income statement volatility.

FAS 138 separates all credit-risk components and allows companies to hedge only the benchmark interest rate – Libor or Treasury in the US, and the appropriate benchmark in foreign markets. At the same time, FAS 138 also defines credit risk as the spread above the benchmark, which includes both company and sector-specific spreads.

While companies will have discretion in designating the benchmark rate, they will have to designate similar benchmarks for similar hedges, and include their choice of benchmark in the original hedge documentation (since it will determine all subsequent tests of effectiveness). As is the case everywhere else in FAS 133, designations must be made at inception and must not be 'altered' later when effectiveness tests are less than stellar. The amendment does not stop there,

though. FAS 138 also requires that in cash flow hedges of variable rate instruments that are not based on a benchmark rate (say, a prime-based borrowing), the designated risk must be the overall risk. In practical terms, this means that if a company chooses a hedge instrument based on a different index (say, Libor) to hedge a non-benchmark exposure, the basis risk between the two is guaranteed to generate ineffectiveness.

Another FAS 138 caveat is that companies must choose a method to evaluate the effectiveness of IR cash flow hedges which discounts all of the estimated cash flows of the hedge item (contractual cash flows in most cases), and not exclude any of the expected cash flows. Since this rule prevents firms from excluding the portion of the debt coupon, for example, that reflects the spread above the benchmark interest rate, if the swap fails to qualify for the shortcut, the long haul method would generate some ineffectiveness even in otherwise perfectly matched swaps.

FAS 138 also amends the use of the shortcut method. It prevents firms from using the shortcut method in cash flow IR hedges when the cash flow of the hedged item and the hedge are not based on a benchmark interest rate. Similarly, the shortcut method is not applicable to fair value IR hedges in which the variable leg of the swap is based on an index that is not a benchmark rate of interest. ■

However, in all other cases, the ease of basis adjustment is out, and the cumbersome task of marking it to market is in.

Seeking amendments

Hedge managers' frustration with the interest rate aspects of FAS 133 was evident in the avalanche of comment letters sent to the FASB as the date of final adoption neared. While most of the letters to the Board requested (and ultimately secured) a one-year delay in the adoption of the standard, the next most frequent request had to do with the definition of interest rate risk.

So when it became time for the FASB to consider amendment proposals, it narrowed them down from an initial list of over 10 to six, two of which were interest-rate related: the redefinition of the risk-free rate and partial-term hedging.

The good news is that the Board has amended FAS 133 (with FAS 138, see box above). It has redefined the benchmark interest rate, thereby making it possible for companies of various credit standings to hedge their debt while disregarding the credit risk associated with their particular organisation as well as the sector spread.

The bad news is that partial-term

Partial-term hedging with forward rate agreements

Although the FASB put the kibosh on the partial-term hedging amendment last January, FAS 133 doesn't strictly forbid fair value partial-term hedges. Although it is unlikely that any fair value, partial-term hedge could pass the standard's strict muster for effectiveness – or a CFO's risk tolerance. (An amendment would have allowed companies to more easily offset a hedge against the hedged item by changing the definition of the hedged item.)

Some auditors have suggested that 'massaging' the notional amount of an IR swap (which theoretically could nudge a given transaction into the scope of effectiveness) or early liquidation of four-year swaps could achieve the same result. However, another possible approach presented by Greenwich Treasury Advisors' Jeff Wallace may be using forward rate agreements (FRAs). FRAs are essentially the floating portion of an IR swap. They involve an agreement between two parties on an interest rate to be paid at a future date of settlement. The principal amounts are agreed, but never exchanged, and the contract is often settled in cash, hence the exposure is limited to the difference between the contractual

and actual interest rates on the day of settlement.

In theory, to hedge one year's worth of a longer-term exposure, a company would buy four successive three-month FRAs, or the equivalent of a one-year interest rate swap. If the FRA has the same index as the floating rate index of the underlying exposure, the hedge is perfectly effective, since the effectiveness testing is only performed on that specific interest period reset and the critical terms are the same. Hence, the change in fair value goes into OCI until such time as the interest expense is recognised into earnings.

Using the same principles, FRAs could also be used to convert a fixed to a floating rate exposure using a fixed rate debt swap.

While this may not technically qualify for the coveted short-cut method, the hedge would be essentially effective, making effectiveness/ineffectiveness testing relatively simple because the test is on the I/R cash flow hedged by each individual FRA – and not the entire swap debt. ■

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hedging (in which an instrument with a shorter duration than the underlying exposure is used) failed to generate Board support. Effectiveness, therefore, will be hard to come by for companies that use, say, a three-year swap to lock in – or convert into floating – only the first three years of a 10-year debt deal. (See box on page 44 for a possible way around this problem).

Common difficulties

So while FAS 138 offers companies some relief, it does not resolve many of the IR-related issues. In fact, most treasurers and risk-management experts agree that interest rate risk issues remain among the least understood in the FAS 133 arena.

Still, some ramifications are, by now, becoming clearer. For example, there will be no hedge accounting for intra-company interest rate derivatives, only FX, and using anything other than a perfect swap (under the shortcut

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method) will most likely generate some (and sometimes significant) income volatility.

Hedging of CP issuance will continue to pose a problem, since a one-year instrument cannot be effective in

hedging the periodic issues of variable-term paper. So treasurers might have to place paper in similar-duration baskets, and then offset them.

Standalone IR options will also prove problematic, since options (unless a last-ditch attempt by Fannie Mae to change accounting for time value in options wins Board approval; see FAS133.com for more details) will almost always generate income volatility since the time value must be marked to market in income.

Indeed, some experts, such as Jeff Wallace of Greenwich Treasury Advisors, recommend that companies embed IR options in debt issues to avoid volatility – as long as the options are “clearly and closely related”, they need not be bifurcated and accounted for separately. ■

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