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Exploring Global Hedge Accounting Changes and Their Impacts

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Agenda

1. IFRS 13 Fair Value Measurement – Impact on Derivative Valuation and Hedge Accounting
2. Hedge Accounting Policy Election – Deciding Between IAS 39 and IFRS 9
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IFRS 13 Fair Value Measurement
Impact on Derivative Valuation and Hedge Accounting

Overview

- IFRS 13 is a new accounting standard
  - Effective Jan 1, 2013
  - Converged with US GAAP
- Defines how to measure fair value
  - Modifies definition in IAS 39
- Derivatives are impacted
  - Incorporate credit risk
  - Use a market participants approach
  - Calculate CVA-DVA

Practical Implications

- Understanding the impact
  - CVA-DVA – complex to calculate properly
  - Impact on earnings
  - Additional disclosures
  - US GAAP – IFRS differences
    - Hedge accounting
- Choosing an approach
  - Materiality
  - Cost / benefit

Hedge Accounting Policy Election
Deciding Between IAS 39 and IFRS 9

Overview

- Macro hedging project
  - Has delayed release of IFRS 9 hedge accounting guidance
- IASB decided to issue separate IFRS on macro hedging
- IASB provided an accounting policy choice until macro hedging standard issued
  - Continue applying IAS 39
  - Adopt IFRS 9
- Under both choices, IAS 39 macro hedging can continue to be applied until new macro hedging IFRS issued

Practical Implications

- Choosing either IAS 39 or IFRS 9
- How to evaluate
  - Reasons for IAS 39
  - Reasons for IFRS 9

Novation of OTC Derivatives to Central Clearing Counterparties

Overview

- Regulatory changes expected to increase the need to centrally clear trades
- Central clearing results in a transfer to a new counterparty
  - Represents change in key term of a hedging relationship
- SEC's OCA has indicated it would not view this type of transfer as a change in a key term
- IASB amended IAS 39 with similar conclusion

Practical Implications

- Changing a key derivative term results in end of hedging relationship
  - Leads to off-market redesignations
- Relief provided due to anticipated rise in central clearing
- Actions required to avoid redesignation

Accounting for Futures Contracts

Overview

- Regulatory changes may cause rise in use of exchange traded futures contracts
- Exchange traded futures are not customizable products
- Exchange traded futures contracts typically require both initial and maintenance margin

Practical Implications

- Hedging costs are increasing
- Evaluating which product to use
  - Execution costs
  - Margin requirements
  - Customization
  - Hedge ineffectiveness

Overnight Index Swap Rate ("OIS")
A New Benchmark Rate

Overview

- Risk free rate
  - Before credit crisis – LIBOR
  - After credit crisis – OIS
- Use OIS based discount factors to discount derivative cash flows
- Change in valuation methodology
- FASB amended ASC 815 to make OIS a benchmark interest rate

Practical Implications

- Understanding current valuation approach
- Assessing impact of changes
  - Materiality
  - Cost / benefit
  - Fair value hedges
  - Use of Fed funds derivatives

Key Hedge Accounting Considerations from IFRS 9

Overview

- New IFRS hedge accounting standard
- Likely effective January 1, 2016
  - Early adoption permitted
- Considerations
  - Risk management objective
  - Documentation
  - Hedgeable risks expanded
  - Aggregated exposures
  - Rebalancing hedging relationships
  - Effectiveness testing
  - Costs of hedging

Practical Implications

- Benefits
- Costs / challenges
- Timing

Accounting for Costs of Hedging Under IFRS 9

Overview

- Differences between IAS 39 and ASC 815
- IFRS 9 -“cost of hedging” concept
  - Time value of options
  - Forward element of fx forwards
  - Currency basis
- Similar, not identical to US GAAP

Practical Implications

- Improvement over IAS 39
  - Record certain changes to OCI instead of expensing immediately
  - Systematic and rational basis

Proposed ASU: Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps

Overview

- FASB defining "public entity"
- Proposal by Private Company Council to simplify hedge accounting for private companies
  - Provide a simplified accounting approach for a specific hedging strategy
  - Proposing "simplified shortcut" method
- Sent to FASB for endorsement
- If accepted, would update ASC 815

Practical Implications

- Applicability
- Impact
- Timing

The Future of Hedge Accounting under US GAAP

Overview

- FASB amending hedge accounting standard
- No completion date as of yet
- What approach will FASB take?

Practical Implications

- Potential changes
- Benefits
- Challenges

Appendix

Additional Information

IFRS 13 Fair Value Measurement
Impact on Derivative Valuation and Hedge Accounting

Overview

- IFRS 13 Fair Value Measurement
  - Became effective Jan 1, 2013
  - Defines the framework for measuring fair value
  - Is a converged standard with ASC 820
- The definition of how to measure fair value in IFRS 13 is different from the previous guidance in IAS 39
- IFRS 13 requires credit risk to be incorporated into the fair value measurement using an approach that a market participant would use
  - This is accomplished by calculating a credit/debit valuation adjustment ("CVA -DVA")
- Treatment of CVA-DVA for cash flow hedges is different under IFRS than it is under US GAAP, although currently there is some diversity in practice under IFRS

Practical Implications

- Calculating a CVA-DVA properly using the same approach that a market participant would use is very complicated and may present practical challenges for most companies to implement
  - Companies should carefully consider how they plan to change existing valuation methodology to accommodate calculating CVA-DVA
  - Consider the composition of their portfolio, existing knowledge and skillset, and available resources
- Under IFRS, the CVA-DVA will have an immediate impact on earnings for derivatives that are not designated in hedging relationships and those that are designated in fair value hedging relationships
- With respect to cash flow hedges under IFRS, the treatment is quite different from US GAAP:
  - CVA-DVA is included in the measurement of the actual derivative, but not the hypothetical derivative
  - May cause true economic ineffectiveness to be masked by the CVA-DVA or cause a hedge to fail even if perfectly effective economically
  - US GAAP permits the same CVA to be included in both the actual and hypothetical derivative
- Expect an increase in volume and complexity of related disclosures

Hedge Accounting Policy Election
Deciding Between IAS 39 and IFRS 9

Overview

- Macro hedging is a practice under IAS 39 that permits entities to designate derivatives in a fair value hedging relationship of interest rate risk on a portfolio of financial assets and financial liabilities
- Macro hedging will be addressed in a separate IFRS rather than as part of IFRS 9, although the specifics of how it will be applied are currently being developed
- The IASB is considering whether and how the macro hedging concept could be extended to apply to corporate cash flow hedging programs
- Because the majority of the hedge accounting guidance under IFRS 9 has been finalized, with the exception of the macro hedging guidance, in April 2013 the IASB decided to provide entities with an accounting policy choice between applying the new hedge accounting requirements of IFRS 9 and retaining the existing requirements in IAS 39
  - It was noted that the accounting for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities in IAS 39 would still be available to those who apply the new IFRS 9 hedge accounting model

Practical Implications

- Companies applying hedge accounting under IFRS will need to assess whether they should:
  - Make the accounting policy choice to continue applying the IAS 39 hedge accounting provisions until the macro hedging standard is issued
  - Adopt IFRS 9’s hedge accounting provisions once issued, even though the macro hedging provisions have not been finalized
- The completion date of the macro hedging project is uncertain
  - A final standard may not be issued until the end of 2014
  - This could lead to some companies continuing to apply IAS 39 for a considerable period of time

Novation of OTC Derivatives to Central Clearing Counterparties

Overview

- Under the Dodd-Frank and EMIR rules, OTC derivatives will increasingly be required to be cleared through central clearing agencies / organizations (“central counterparties”)
- Centrally clearing an OTC derivative results in a transfer of the derivative from the original counterparty to the central counterparty, representing a change in a key term in a hedging relationship
- The SEC’s Office of the Chief Accountant has indicated its views on this matter in the form of a letter to ISDA indicating it would not view this type of transfer as a change in a key term
- The IASB has amended IAS 39 with the same conclusion (such amendment will also be included in IFRS 9)

Practical Implications

- Under both US GAAP and IFRS, if a key derivative term is changed (e.g. counterparty, notional amount, reset date, index, etc.) the corresponding hedging relationship is ended
- A new hedging relationship involving the new derivative terms must be created
  - When this occurs, the fair value of the derivative is typically not equal to zero, meaning it is “off-market”
  - The off-market nature of the derivative typically leads to the recognition of some hedge ineffectiveness (i.e. unwanted earnings volatility) and added complexity associated with the ongoing accounting for the relationships
- The views expressed by the SEC and the amendment to IAS 39 should result in the avoidance of redesignating in off-market hedging relationships OTC derivative transactions novated to central counterparties
  - The SEC’s position is that this must be documented in hedge documentation whereas the amendment to IAS 39 does not include similar language

Accounting for Futures Contracts

Overview

- Dodd-Frank rules may cause companies to begin using exchange traded futures contracts rather than OTC derivatives
- Exchange traded futures contracts are not customized products
- Exchange traded futures contracts typically require both initial and maintenance margin to be posted, typically in the form of cash or liquid securities

Practical Implications

- Regulatory changes are resulting in higher costs of hedging for financial institutions, which are passing along some of these costs to their corporate customers
- Exchange traded futures contracts are likely to be less expensive to execute than OTC derivatives
- However, using exchange traded futures contracts typically requires companies to use working capital for posting initial and maintenance margin rather than deploying it to other productive business activities
- Further, unlike OTC derivatives, exchange traded futures do not typically contain terms that will perfectly match up with the terms of hedged transactions
    - As a result, using futures contracts will likely lead to hedge ineffectiveness
- Companies will need to weigh the pros and cons related to choosing either a futures contract or an OTC contract

Overnight Index Swap Rate ("OIS")
A New Benchmark Rate

Overview

- Prior to the credit crisis, LIBOR based discount factors were traditionally used to discount derivative cash flows
- Since the credit crisis, the market has changed to using OIS based discount factors to discount derivative cash flows because they more accurately reflect a "risk-free" rate
- This results in a change to the methodology used to measure the fair value of derivatives and primarily impacts discounting and the construction of the LIBOR forward curve
- OIS recently became a benchmark interest rate under ASC 815

Practical Implications

- Companies should evaluate the need to make changes to their existing valuation methodology to incorporate using OIS based discount factors rather than LIBOR based discount factors
  - Assess materiality of using (or not using) OIS discount factors
  - Requires obtaining and using OIS discount factors to discount cash flows
- Earnings impact from OIS based discount factors tends to be more significant for:
  - Longer dated and off-market trades
  - Fair value hedging relationships
- Fair value hedging relationships of benchmark IR risk impacted
  - OIS discount factors used to discount the interest rate derivative's cash flows
  - LIBOR discount factors used to discount the hedged item's cash flows
- Fed funds derivatives may see increased demand due to the positive impact on certain hedging relationships
  - Hedges of fixed rate debt instruments
  - Hedges of forecasted debt issuances

Key Hedge Accounting Considerations from IFRS 9

Overview

- Key things to consider under IFRS 9:
  - Risk management objective is a major focus
  - Documentation of hedging strategy is still required
  - Hedgeable risks have been expanded to include components that are both reliably measurable and separately identifiable
  - Ability to hedge “aggregated exposures” has been introduced which can consist of both exposures and derivatives
  - Ability to record changes in time value to other comprehensive income rather than to expense
  - Introduction of the concept of “rebalancing” a hedging relationship
  - Effectiveness testing changes:
    - Prospective only
    - Demonstrate an economic relationship exists
    - Analyze sources of ineffectiveness
    - Appropriate hedge ratio must be designated
    - Quantitative methods not required, but may be needed to demonstrate effectiveness

Practical Implications

- The changes to the hedge accounting guidance are geared towards simplification, but could have varied interpretations
- Effective date likely to be January 1, 2016
- Companies applying IFRS will benefit from the following:
  - Expansion in risks permitted to be hedged (especially important for hedging commodity risk)
  - Ability to record time value, forward element of forward contracts, and currency basis to OCI rather than to expense
  - Changes to effectiveness testing requirements
- Companies could find the following items challenging to administer:
  - Rebalancing a hedging relationship
  - Hedging aggregate exposures
  - Tracking items like time value and cross currency basis
  - Knowing when to quantitatively measure effectiveness vs. performing a qualitative measurement
  - Incorporating CVAs into the assessment of effectiveness and measurement of ineffectiveness

Accounting for Costs of Hedging Under IFRS 9

Overview

- Due to the provisions of IAS 39, time value is accounted for as an excluded component and is not permitted to be recorded to OCI in hedging relationships. Instead, changes in time value are expensed as they occur
- IFRS 9 includes a provision that permits time value of option contracts, the forward element of forward contracts, and cross-currency basis, to be treated as “costs of hedging” and separately tracked and recorded to OCI rather than recorded to expense
- This will make the treatment of these items <u>similar</u> to the treatment under US GAAP, but <u>not identical</u>

Practical Implications

- The change represents an improvement over IAS 39 in that it will allow companies to recognize changes in time value, the forward element of forward contracts, and cross-currency basis in earnings on a systematic and rational basis rather than as those changes occur
- Time value of options
  - Transaction related hedged item
  - Time-period related hedged item
- Systematic and rational basis used to reclassify amounts to earnings
  - Straight-line
  - Caplet method

Proposed ASU: Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps

Overview

- On August 7, 2013, the FASB issued an exposure draft, Definition of a Public Business Entity: An Amendment to the Master Glossary, in order to more clearly define what a public entity is for accounting purposes
- This guidance is aimed at 1) providing a single definition of a public entity for use in US GAAP, and 2) identifying the types of organizations that would be excluded from the scope of the PCC
- Private companies would be provided with additional methods of accounting for receive variable / pay fixed rate interest rate swaps
- Two new methods were initially proposed by the PCC:
  - Simplified shortcut
  - Synthetic instrument
- PCC revised proposal only includes simplified shortcut
  - Applies a simpler method of accounting to a very specific, simple hedging strategy
- Sent to FASB for endorsement
- If endorsed, will become part of the Accounting Standards Codification
  - Estimated to become effective for 2015, but early adoption permitted

Practical Implications

- Definition of a public company is important because it will impact which companies fall under the scope of the PCC proposals
- The PCC proposal would apply to all private companies
- Both spot starting and forward starting swaps would be included
- Documentation requirements would be relaxed
  - Companies would have until they file their financial statements to complete hedge documentation
- Fair value measurement would be simplified
  - CVAs would not be required to be included in the fair value measurement of derivatives
- Effectiveness testing would not be required

The Future of Hedge Accounting under US GAAP

Overview

- FASB issued an ED in June 2008 to amend FAS 133
- In May 2010, FASB subsequently issued a comprehensive Accounting Standards Update for financial instruments, including revisions to the existing hedge accounting guidance
- In February 2011, FASB issued a discussion paper soliciting input on the IASB's hedge accounting proposal
- The hedging component of FASB's financial instruments project is open and currently does not have a scheduled completion date
- Questions exist around the ultimate direction FASB will go with hedge accounting
  - Surgical approach as was taken in previous ED
  - Rewrite approach similar to that taken by the IASB with IFRS 9

Practical Implications

- Similar to IFRS 9, well intentioned changes geared towards simplification could have varied interpretations
- Potential changes include:
  - Hedgeable risks
    - Will commodity price risk be permitted to be hedged? IFRS 9 allowed for this – a key benefit
    - Will other non-benchmark interest rates be permitted to be hedged?
    - Generally, going to an approach like IFRS seems like it would be an improvement (separately identifiable and reliably measurable)
  - Effectiveness testing requirements
    - Will reasonably effective become the standard?
    - What does reasonably effective mean?
  - Measurement of ineffectiveness
    - Will both over and under hedges need to be reflected in earnings for cash flow hedges?

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