



Hedging Compliance - Necessary Evil or Just Plain Evil?

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Depending on your perspective, the horizon is either glowing with opportunity or marred by an ominous and potentially damaging blot. The arrival of IAS 39 - like that of FAS 133, its US counterpart - has divided the industry into two factions: those who welcome tighter regulation (essentially regulators, controllers and CFOs) and those who believe their ability to manage risk will be massively frustrated and possibly curbed altogether, i.e. treasurers.

The hallowed turf of hedge accounting has been mired by potential disasters for some time. Think derivatives; think Orange County; think Barings. It was only a matter of time before P&L discrepancies resulting from the use of derivatives had to be accounted for and, like it or not, that time has now arrived.

But what impact did respondents to the GTNews snapshot poll believe the new environment would have on these once green pastures? In short, the outlook is far from rosy.

A Change for the Better?

Sixty nine per cent of respondents agreed that hedge accounting compliance reduced hedging activity, while 68 per cent felt it inhibited best practice in FX management.

Seventy per cent of all corporates polled (a total of 146) believed the halcyon days of hedging were threatened, accepting that accounting compliance would reduce hedging activity. Furthermore, three quarters of corporate respondents believed that compliance inhibited best practice in FX management.

Corporates felt most ill at ease regarding the potential for an increase in P&L volatility, with 71 per cent noting their apprehension. Financial institutions were close behind, 70 per cent of respondents from this sector believed new regulations would ramp up volatility.

Financial institutions (FIs) too, foresaw a decline in hedging activity, 62 per cent felt that compliance with hedge accounting regulations would reduce volumes. Fifty nine per cent believed that hedge accounting would inhibit best practice in FX management.

The slight disparity in responses from corporates and financial institutions may be explained by the greater resources and expertise generally available to the latter - and the fact that derivatives transactions are core to many of their client services and proprietary businesses.

On a regional basis, respondents from North America, many of whom will have had experience of FAS 133, agreed that hedging activity had diminished under the new regime. Fifty nine per cent agreed that the new regulatory environment had inhibited best practice in FX management.

These figures aren't a million miles away from predictions being made in Western Europe, where 68 per cent of respondents predicted a decline in hedging activity and 69 per cent (10 percentage points more than in North America) believed the new environment would negatively impact best practice as regards FX management.

African/Middle East (82 per cent) and Latin American (86 per cent) respondents were most convinced that hedging activity would diminish under the new regulations.

Interestingly, the largest percentage of firms fearing or experiencing a reduction in hedging activity were in the \$100m-\$500m bracket (83 per cent) while 'only' 61 per cent of larger firms (\$500m-\$1bn) and 66 per cent of \$1bn+ organisations, echoed this sentiment. This suggests that larger firms have greater resources, allowing them to work within the new regulations without compromising hedging strategy.

When asked whether they agreed that hedge accounting compliance inhibited best practice in FX management, Western Europe and Asia Pacific respondents accepted the general belief that best practice will suffer as a consequence (69 per cent and 67 per cent respectively), while North American replies indicated less concern; 59 per cent of respondents from this region believed that hedge accounting compliance inhibited best practice in FX management. On the one hand, FAS 133 offers more flexibility to the treasurer than IAS 39, leaving North American firms operating under a less onerous regime than Europe. On the other hand, North American treasurers have now been grappling with the reality of FAS 133 for two to three years; Europeans do not yet have the benefit of this experience.

A Dying Art?

Clearly, concerns about about the new regulatory environment and its impact on hedging, but whether the changes will spark a dramatic impact on hedging in the long term remains to be seen.

"[These results] are consistent with the reaction of U.S. treasurers to the FAS 133 legislation," says Susan Skerritt, Partner at Treasury Strategies. "In particular, after the implementation of FAS 133, there was a reduction in hedging activity. However, this is most likely to occur among mid-sized corporations (\$100-500m) where limited treasury resources make it even more difficult to comply with the regulatory tracking and reporting requirements."

"By their very nature, these rules are complex," explains Jiro Okochi, CEO and Co-founder of Reval. "They require greater levels of planning, reporting and attention and therefore limit previous flexibility. So it doesn't surprise me that most companies believe that hedge accounting rulings such as FAS 133 and IAS 39 have a negative impact on their hedging programs."

Okochi also draws attention to the requirement of reporting on the income statement and balance sheet (as opposed to prior footnotes), which he believes will increase the potential for volatility almost by definition. "Not until users become more comfortable with the rulings and the automated processes that can reduce the complexity of compliance will their concerns be reduced," he warns. However, Okochi was surprised at the degree of concern still pervading the US market: "Given the head start of North American corporations, I am surprised that they are not more sanguine than their international counterparts who are just beginning to face the new rulings."

It would appear that the impact of new hedge compliance regulations, despite the widely debated concerns, may still catch many treasurers sleeping.

"There will be a shock affect, mainly from the people at the board or CFO level who are afraid of any P&L volatility which may result from the non-application of hedge accounting," agrees Olivier Cattoor, Manager at PricewaterhouseCoopers Risk Management. "They will request the treasurer not to generate any substantial additional P&L volatility in the income statement. Since the treasurer does not want to lose his job, he will revert to simpler hedging strategies, but this is probably a short to mid-term temporary effect."

Indeed Cattoor argues that hedge activity should not necessarily fall across-the-board, rather, that the usage of certain types of instrument will flag, at least initially.

"Exotic derivatives will be harder to get hedge accounting for [and I believe] this may be what

people are referring to when they say hedging activity will fall," says Cattoor. "IAS 39 will probably force companies to go back to more simple hedging activities using simpler derivatives."

However, he believes this trend will quickly subside. Having become accustomed to hedge accounting with simple derivatives, treasurers will eventually rediscover the confidence to use more complicated instruments once again.

Indeed, most experts accept that an initial drop in hedge activity is inevitable, but that this should not be taken as a sign that hedging is a dying art.

Ira Kawaller, an independent consultant, agrees, accepting that, "Some entities will forego hedging if they can't apply hedge accounting." However, he notes that while 69 per cent of the population agreed with this, this percentage doesn't mean that 69 per cent of the hedges aren't getting done. "It just means that most people appreciate that some hedges aren't happening," he explains.

Kawaller believes that the compliance issue is particularly relevant to entities with commodity exposures, who need to designate the full price of the forecasted purchase or sale (rather than a benchmark price) as the 'hedged item'. "This requirement frequently precludes passing prospective effectiveness tests," he explains.

The degree of effectiveness required to comply with IAS 39 is in itself a highly contentious issue. The IASB has demanded close to 100 per cent effectiveness, a target most see as unrealistic. PwC's Cattoor explains: "The IASB wants the hedge to be almost 100 per cent effective prospectively. This is probably unrealistic, most hedges will never be 100 per cent effective as there is always some basis risk between the derivative and the hedged exposure. Even an interest rate swap perfectly matching the critical terms of a fixed rate debt is not a perfect hedge prospectively, since the movements in the value of the floating leg of the swap are not mirrored in the debt, resulting in the test sometimes being well below 100 per cent."

More Clarity Needed

It seems a lack of clear guidance and practical support from the IASB is, to a large extent, responsible for the many fears currently surrounding IAS 39. "There is not a tremendous amount of guidance behind [IAS 39]," according to Matthew Daniel, Director of FX Analytics and Risk Advisory at ABM AMRO. "The implication is that there is a lot of flexibility behind the standard and they really want to avoid giving too much guidance on some of these issues because that would defeat the fact that it is a principal-based standard." In Daniel's view this has both positive and negative implications: positive in that it increases flexibility in the application of IAS 39;

negative as it creates uncertainty and questions in people's minds. In fact, the level of awareness regarding hedge compliance is surprisingly varied, claims Cattoor: "We have found that the level of education varies across Europe and the degree of familiarity with IAS 39 varies from market to market. In the North of Europe, in Scandinavia, the level of awareness and preparation is very high, while the UK is probably below the expected level. In the Centre and South of Europe the level of awareness of IAS 39 needs to be strongly increased."

An Uncertain Future

Clearly, there are rumblings on the horizon, but we have yet to see whether or not they are storm clouds. The new regulatory environment is undoubtedly going to impact firms in terms of both cost and resource allocation, but will the resulting benefits be enough to justify the effort?

Not only may treasurers find their ability to manage financial risk severely proscribed, they may end up bearing additional risks if they curtail or simplify their hedging programs. The costs of compliance through the purchase of risk management and reporting tools has become an important consideration for treasurers, CFOs, CEOs, and boards. However, Reval's Okochi believes that the expenditure can be justified: "The costs may be quite small when compared to those of bearing additional business risk," he explains. "Some companies will resort to reducing their exposure on balance sheet. They may for example negotiate more overseas contracts in their functional currency, or issue debt to the duration they would like. In either case, the company may incur implicit costs or give up benefits in doing so." Okochi also claims that the benefits to shareholders and, indirectly, to corporate financial risk management practices will far outweigh any impact of volatility on the company's share price. "Shareholders will benefit because they will be aware of the business risks the corporation is undertaking and the efforts it is making to hedge those risks. Corporates will benefit from improved risk management because corporations are finally being forced to invest in the kinds of tools that will give them greater insight into the nature and management of their business risks."

To ease the transition, some treasurers are choosing to mitigate and offset risk by centralizing risk management. By doing so, explains Treasury Strategies' Skerritt, it is possible to accurately measure the exposures an organization faces. "As a result of more precise measurement, it is possible to identify natural hedges that reduce external hedging activity."

But will the benefits of compliance outweigh the negative impacts of P&L volatility? "As we all

know, there is keen concern over corporate governance," says Skerritt. "These regulations and compliance with them is an important indication that the corporate world is monitoring itself tightly. While the pendulum often swings too far in reaction to market forces, taking a broad perspective, the benefits of compliance do outweigh the negative impacts of P&L volatility. However, the potential volatility cannot be ignored and requires more careful management. Arguably, this raises the importance of the treasury function and the role of the corporate treasurer."

Limited Choices Available

At the end of the day, the debate and criticism over new hedge compliance regulations is arguably redundant as no amount of complaining or tantrum throwing will prevent their introduction, meaning that treasurers are going to have to adapt to constraints. As PwC's Cattoor concludes: "IAS 39 is far from perfect and if the IASB were willing to make some limited changes to the standard on top of those already introduced then it would probably make it easier for many companies. However, the convergence project with US GAAP prevents the IASB from introducing changes to IAS 39 which would cause significant reconciliation differences with FAS 133. But ultimately, you either don't apply hedge accounting and incur a lot of P&L volatility, or you do apply hedge accounting and invest in processes and education - and perhaps you need to revert to simpler hedging strategies."

Of course, the third option is to stop hedging, but this would probably be the worst of both worlds.

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