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Documenting Interest Rate Hedges

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Motivated by the Financial Accounting Standards Board's (FASB's) intent to provide greater transparency, FAS 133 makes a dramatic departure from past accounting practice by requiring derivative contracts to be marked-to-market and recorded as assets or liabilities on the balance sheet. In general, this standard requires gains or losses from derivative positions to be recorded in earnings, however, special hedge accounting treatment, which enables a matching of the income effects of the derivative with those of the associated "hedged item," may be applied when prerequisite conditions are met – the first being that the intended hedge relationship must be documented at the inception of the hedge.

Types of exposures and associated accounting treatment

This requirement may be satisfied by filling out a form *for each prospective hedge*. This documentation requires the following information:

- A description of the hedged item.

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- A statement designating which type of hedge accounting is being followed (e.g., fair value, cash flow, or net investment in foreign operations)
- A description of the hedging derivative
- A statement of the intended hedge objective, including a discussion of the nature of the risk being hedged, and any related hedge strategy or methodology
- A discussion explaining how the hedging instrument's effectiveness in offsetting the change in fair value or cash flows associated with the hedged risk will be assessed.

With respect to interest rate exposures, banks may face as many as five distinct types of risks. Those risks and the associated hedge accounting treatments are presented below:

Interest rates

<u>Source of Exposure</u>	<u>Accounting treatment</u>
Uncertain interest expense/income	Cash flow
Fixed interest expenses/income	Fair value
Anticipated debt issuance	Cash flow
Anticipated investment or purchase of fixed income securities	Cash flow
Price risk associated with fixed rate available-for-sale assets	Fair value

For cash flow hedges, the exposure must pertain to a forecasted, uncertain cash flow. Gains or losses from derivatives must be evaluated, with a determination made as to how much of the result is "effective" and how much is "ineffective." The ineffective component of the hedge results must be recognized in current income, while the effective portion is initially posted to "other comprehensive income" and later re-classified as income in the same time frame in which the forecasted cash flow affects earnings.

Fair value hedge accounting applies when the exposure being hedged is associated with the price of an asset, liability, or a firm commitment.

Under this accounting, gains and losses from the derivative are recorded in earnings (i.e., the same as the treatment for speculative derivative positions or those situations in which the hedge criteria are not satisfied); and in addition, assuming the hedge qualifies for this special treatment, the underlying exposure must also be marked-to-market due to the risk being hedged; and these results must flow through current income, as well.

Hedge-able risks

Once the exposure being hedged is determined, the hedged item must be described with sufficient specificity such that their identification can be determined without any ambiguity. The kind of information that should be assembled would vary, depending on the nature of the risk being hedged.

FAS 133 allows users to think about interest risk as being composed of risks associated with changes in a benchmark interest rate (either a LIBOR-based swap rate or a U.S. treasury interest rate), changes in a credit spread (i.e., the difference between the full interest rate and the benchmark rate), or both; and with this orientation, the standard allows the hedger to specify the hedge objective as being designed to offset changes associated with either or both of these potential exposures. *The documentation must be explicit about whether the objective of the hedge is to offset only changes in the benchmark interest rate or, instead, if the objective is to offset the effects of the entire interest rate change.*

The most frequently used interest rate derivative is the interest rate swap, and when used in its most common application -- to swap from variable interest expenses/revenues to fixed, or vice versa -- the stated hedge objective in the documentation should be to offset the changes in the benchmark interest rate. Sometimes, however, swaps may be used in a different way -- particularly in fair value hedging situations. If the hedger intends to offset the effect of a full interest rate change, comprised of changes in both the benchmark rate and the credit spread,

this intention should be stated in the documentation.

Effectiveness considerations

A further prerequisite for authorizing special hedge accounting treatment is that the hedge must be expected to be highly effective in offsetting the fair value or cash flows associated with the risk being hedged. In certain cases, making this assessment is trivial. Specifically, if the derivative is a swap, a forward contract, or an option that is tailor-made to an associated hedged item, where all the critical terms of the derivative and the hedged item are the same (i.e., size, reset and payment dates, and market conventions), perfect effectiveness may be assumed. In these situations, a quarterly verification that the matching conditions have not changed and are still in effect is required.

In the more general case, the critical terms of the derivative may not match up perfectly with those of the hedged item. For instance the two might have different sizes, (somewhat) different underlyings, different timing of critical dates, or different pricing conventions at work, in which case at least some degree of ineffectiveness must be expected, and a more formalized discussion would be required to describe the methodology used in the determination of whether the "highly effective expectation" can be satisfied.

FAS 133 provides little in the way of explicit guidance about how such effectiveness assessments should be made, allowing a fair amount of discretion on the part of reporting companies. Nonetheless, it seems that correlation analysis will likely be the predominant way in which companies will address this requirement. A company must be able to demonstrate that the prices (or interest rates or exchange rates) associated with the hedged item and those of the hedging derivative are sufficiently highly correlated (e.g., an R-squared of 0.8 or higher) in order to conclude that the hedge will be highly effective.

The documentation pertaining to the methodology of the effectiveness test must be sufficiently specific to allow an independent

third party to replicate the test result. Thus, it should include the data source(s), the number of observations in the data sets, data frequency (e.g., daily, monthly, quarterly, etc.), and any other details about the procedure that would enable this independent verification.

Concluding remarks

Often the biggest criticism of hedge documentation is that it uses boilerplate language that obscures, rather than clarifies, exactly what's going on. Preparers could likely avoid this criticism if they embrace the idea that the documentation should give the reader a clear understanding of what's being hedged, and why and how the hedge will work. In general, a more expansive discussion will likely enhance the prospects of complying with the standard.