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IAS 39
Corporates - Insights from current practice

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BarCap's Accounting Solutions team

Dedicated to client accounting issues

- Specialists with combined accounting and financial product expertise to help clients assess accounting impact of transactions
- Designing transactions to meet economic and accounting requirements
- Facilitating dialogue between client and auditor re derivative and financing transactions
- 'Encouraging' accounting firms make decisions/interpretations on specific issues where there is little detailed accounting guidance
- Keeping key clients informed of developments

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First of all..

- Barclays is acting solely as principal and not as advisor or fiduciary. Accordingly you must independently determine, with your own tax, legal, regulatory and/or accounting advisors, the appropriateness for you of any transaction before entering into it

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IAS 39 reporting so far

- Generally, no significant IAS 39 horror stories so far
  - (though early days as many companies have elected not to apply IAS 39 to comparatives)
- Other areas of IFRS in the headlines
  - Pension deficits: impact on distributable reserves
  - Goodwill on acquisitions: no longer amortised, so a large increase in earnings for many companies
  - Balance sheet reclassification and gross up of assets and liabilities
    - Potential impact on key ratios and covenants

To what extent are companies seeking to apply hedge accounting to 'compliant' derivative hedges?

Generally…

- Costs vs Benefits decision
- Hedge accounting for larger, longer dated transactions (swaps, currency swaps)
  - Less so for short dated hedges (mainly FX)
- Dependent on tolerance levels for P&L volatility

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Alternatives to ‘full’ hedge accounting

For compliant and non-compliant derivatives

- Fair value election
  - Are many companies likely to use this election ?
- Short dated FX – hedge accounting is often not worth the effort anyhow
- Some companies have segregated their derivative portfolio
  - IAS 39 compliant portfolio
  - Non-compliant portfolio (economic, value added hedges, HA not worth the effort)
- Generally, companies becoming more comfortable with MTM vol especially if explainable and quantifiable
- E.g. Rolls Royce IFRS statement
  - Accounting will not drive hedging policy
  - Not applying hedge accounting to FX hedges (significant impact)

Hedging exposures that are not eligible for hedge accounting

- Examples:
  1. Forecast cash flows that are not certain enough to meet 'highly probable' criteria
     - E.g. foreign currency revenues in future years
     - E.g. forecast interest payments beyond maturity of existing debt
  2. Certain types of 'overlay' swap (eg to fix one leg of floating floating XC basis swap used as net investment hedge)
- For good risk management reasons, many companies still want to hedge a portion of the risk
- Therefore some are transacting hedges with less potential MTM vol – e.g. purchased options (inc compound options) or collars
  - Purchased options avoid negative MTM, compared to forwards/swaps
  - Delta less than or equal to 1 (i.e. less than forward/swap)

Hedging with non-compliant/structured hedges

- For some types of structured hedge, partial hedge accounting possible by transacting separately the compliant and non-compliant components
- Example 1: Knock-in Forward
  - Transact as vanilla FX forward (hedge accounting friendly) plus separate binary option (no hedge accounting but limited volatility)
- Example 2: Cancellable swap
  - Sold optionality prohibits hedge accounting
  - Transact as vanilla IRS (HA friendly) + sold swaption (MTM via P&L)
  - *However,* in certain interest rate scenarios, less P&L volatility if hedge accounting is not applied at all

Testing hedge effectiveness

- 'Hypothetical derivative' method for cash flow hedges now more commonplace (some also using for FV hedges)
- Many companies now using statistical methods such as regression to get around inherent problems with 'dollar offset' method (particularly for longer dated IR and XC swap hedges)
- Prospective testing: Numerical test not always required if terms match
- Retrospective testing: Always necessary to numerically test effectiveness if terms match?

Dollar-offset versus statistical methods

	Period end values		Cumulative changes in value		Period by period changes		Effectiveness ratio	
Date	Underlying	Hedge	Underlying	Hedge	Underlying	Hedge	Cumulative	Period-by-period
31-Oct-02	0	2,227,891	0	0	0	0		
30-Nov-02	-853,759	3,039,185	-853,759	811,294	-853,759	811,294	95%	95%
31-Dec-02	-2,546,388	4,954,672	-2,546,388	2,726,780	-1,692,628	1,915,486	107%	113%
31-Jan-03	-1,702,298	3,955,462	-1,702,298	1,727,570	844,090	-999,210	101%	118%
28-Feb-03	-1,863,039	4,078,840	-1,863,039	1,850,948	-160,741	123,378	99%	**77%**
31-Mar-03	-3,626,220	6,064,392	-3,626,220	3,836,501	-1,763,181	1,985,552	106%	113%
30-Apr-03	-4,171,652	6,682,613	-4,171,652	4,454,722	-545,432	618,221	107%	113%
31-May-03	-5,842,189	8,830,336	-5,842,189	6,602,444	-1,670,537	2,147,723	113%	**129%**
30-Jun-03	-5,159,614	7,838,916	-5,159,614	5,611,025	682,574	-991,419	109%	**145%**
31-Jul-03	-6,045,233	8,832,969	-6,045,233	6,605,078	-885,618	994,053	109%	112%
31-Aug-03	-5,738,039	8,419,392	-5,738,039	6,191,501	307,193	-413,577	108%	**135%**
30-Sep-03	-3,051,446	5,450,049	-3,051,446	3,222,158	2,686,593	-2,969,342	106%	111%
31-Oct-03	-10,508	2,090,991	-10,508	-136,900	3,040,938	-3,359,058	**-1303%**	110%
30-Nov-03	-1,257,039	3,450,886	-1,257,039	1,222,995	-1,246,531	1,359,895	97%	109%
31-Dec-03	-1,293,527	3,454,773	-1,293,527	1,226,882	-36,489	3,887	95%	**11%**
31-Jan-04	-2,479,554	4,200,084	-2,479,554	1,972,192	-1,186,027	745,311	**80%**	**63%**
29-Feb-04	-3,955,878	5,292,496	-3,955,878	3,064,605	-1,476,323	1,092,413	**77%**	**74%**

Correlation	-0.989	Correlation	-0.991
R squared	0.978	R squared	0.983

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Causes of hedge ineffectiveness in practice

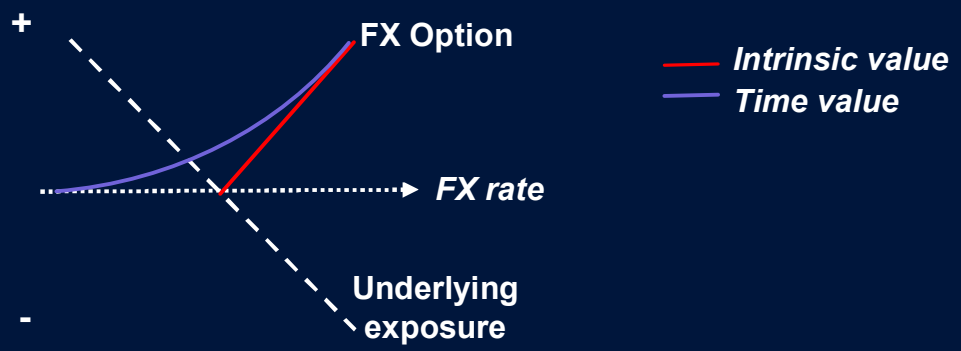
FX hedges

- Spot vs forward method (latter is timing sensitive)
- Off market trades (depends on spot or forward method)
- Time value of options (can be excluded from assessment)

IR and XC swaps

- Credit spread on fixed rate bonds
  - Solution: Exclude credit spread from the bond coupon being hedged
- Testing hedge effectiveness between reset/payment dates
- Off market swaps
- Partial term hedging (there is a solution)

Cash flow hedging with options



- Traditional approach – intrinsic value
  - Effectiveness assessed on changes in *intrinsic* value only (changes in *time value* taken to P&L each period)
  - For FX, intrinsic value based on spot value is the most straightforward
- *Possible* alternative approach (not unlike FAS 133 'G20' approach)
  - *Exposure* can also be viewed as option-like
  - Hedging derivative (option) is a 'mirror image' of hedged exposure
  - Entire changes in value of option (time + intrinsic) therefore effective
  - Are accounting firms allowing this approach?

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Q & A

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