

Bank Asset/Liability Management SCI

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FAS 133 Hedge Documentation: Points to Consider

Having been originally issued in June 1998, the accounting standard pertaining to derivatives and hedging transactions (FAS 133) might seem to be *old news*. But if your bank and/or your customers are just starting to use derivative contracts for hedging purposes, you're likely to find the accounting challenges formidable. Ultimately, the difficulty arises in connection with qualifying for hedge accounting — a special accounting treatment that results in the income recognition of hedge gains or losses concurrently with the income recognition of the exposure being hedged (i.e., the *hedged item*). For derivatives applications pertaining to trading activities, this concern is moot, as the results from both components of the hedging relationship (i.e., hedged items (typically portfolio positions) and hedging derivatives) flow to earnings coincidentally without special accounting treatment. Special hedge accounting becomes a relevant concern, however, if these two effects would otherwise affect earnings in *different* accounting periods, which tends to be the case in most non-trading hedging situations.

The problem is that special hedge accounting isn't automatic. Companies seeking to qualify for this treatment must document their intention, appropriately. And failure to do so could preclude hedge accounting, force non-coincident income recognition, and thereby foster a degree of income volatility that fails to reflect the economics of their hedging orientation.

Merely following the rules doesn't insure that the resulting documentation will necessarily enable hedge accounting to be applied without interruption. But if the preparer is thoughtful and tries to consider potential developments that might impact the hedging relationship along the way, the prospect that hedge accounting will be allowed will be enhanced.

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What follows is a brief listing of some of the more salient factors that should be considered when preparing hedge documentation. It is meant to be helpful without being exhaustive.

Hedge Documentation Preparation. By far, the most ubiquitous of risk management tools in connection with interest rate exposures is the plain vanilla interest rate swap. When using these instruments, the accounting and documentation is simplified if the *shortcut method* can be applied; but this allowance is available only if the use of the swap is a classic textbook example, where all of the critical terms of

the swap match those of the associated debt. And in this case, *match means match*. Beyond this caution, some other considerations are offered:

- When hedging fixed rate debt — whether seeking shortcut treatment or not — the hedged item should refer to a specific debt instrument, but the hedger may elect to hedge only a portion of the debt. When shortcut treatment is intended, despite the cautionary remarks about matching, the two respective fixed rates (i.e., the fixed rate and the fixed rate on the swap) do not have to be the same — nor do they have to rely on the same day-count convention.
- To qualify for shortcut, the debt must be a recognized asset or liability when the swap is initially transacted. Shortcut cannot be elected for hedges involving debt that has not yet been issued.
- Qualifying criteria for shortcut must be re-validated, no less frequently than quarterly.
- For cash flow hedging, consider describing the hedged item as a series of forecasted cash flows *not* tied to any specific loan or counterparty. In this way, the company will protect itself from having to accelerate any accumulated other comprehensive income (OCI) if and when the debt that serves as the original source of the exposure is prepaid or otherwise restructured. Officially, this approach would forego the shortcut treatment, but the accounting entries would be unaffected.
- Cash flows relating to uncertain future interest payments or receipts must be subject to a common risk (e.g., one-month LIBOR, or three-month LIBOR) to qualify as the hedged item in a hedging relationship designed to cover multiple interest rate setting dates.
- The hedging horizon for uncertain interest expenses/revenues can be set for any length for which these similarly typed cash flows are probable, irrespective of the maturity of the debt associated with the most immediately scheduled (or all prospective) cash flows.
- As long as the variable rate that serves at the source of risk is a benchmark interest rate (e.g., a Treasury rate or a LIBOR), the documentation would likely identify the risk being hedged as the risk associated with changes in the benchmark rate. This selection is appropriate even if a non-constant spread is added or subtracted from the benchmark rate in determining the actual interest rate settlements. On the other hand, if the

variable interest rate is other than a benchmark rate (e.g., prime), the risk being hedged should be designated as the risk associated with changes in the entire cash flow.

- Total results of the swap include two components: changes in the present value of the swap over the accounting period and settlements realized during the period. Both are relevant when assessing retrospective effectiveness and/or measuring ineffectiveness.

After swaps, interest rate caps and floors would be the next most popular interest rate hedging contracts. In accounting for these instruments, it is important to recognize that each is really a combination of a series of individual options, commonly called *caplets* and *floor-lets*, respectively, where each component option would be used to hedge a specific, discrete interest rate exposure. For instance, a five-year cap, covering quarterly interest rate resets, is really 20 individual caplets, each designed to hedge a particular reset exposure.

In addition to all of the earlier-discussed points, cap or floor users would have some additional considerations, including the following:

- The reporting entity will need to track value changes for each caplet/floor-let. This tracking is required because reclassification amounts must be calculated on a caplet-by-caplet basis (and the same for floor-lets).
- The starting caplet/floor-let values do not share a common value; that is, longer-dated caplets can be expected to be more expensive than shorter-dated caplets. It is not appropriate to assume that the starting value of a single caplet/floor-let can be found by simply dividing the total cap or floor price by the number of component options.
- When using caps or floors, documentation should reflect that the payoff of this hedging instrument is asymmetrical; that is, the intended offsets occur *only* when the interest rates rise above (for caps) or fall below (for floors) the strike yields specified in the cap or floor contract.
- The intrinsic value (or minimum value) of a cap or floor is found by summing the intrinsic values of the component caplets/floor-lets.
- In general, to minimize the prospect of falling out of hedge effectiveness, and thereby causing hedge accounting to be disallowed, either of two approaches could be used:
 - Exclude the time value (or volatility value) of the cap or floor from the assessment of hedge effectiveness; or

- Apply the G20 method, which bases the effectiveness on the cap's or floor's *total cash flow* and allows the entirety of the change in the value of the cap or floor to be recorded in OCI — assuming the cap or floor matches all of the critical terms of the associated interest rate exposure.

Proper documentation, by itself, is not sufficient for qualifying for hedge accounting — but it is a necessary condition. Beyond the documentation, however, the truly difficult hurdle is proving that (1) the intended hedge can be expected to be highly effective, prospectively, and (2) that it was effective, retrospectively. The best documentation in the world won't get you over that hump if the hedges really don't work. That said, responsible companies pursuing reasonable and appropriate hedging strategies should be able to overcome this hurdle, although it may require appealing to outside expertise to do so.

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Indeterminate Maturity Accounts, Net Interest Margins, Valuations and Risk

First-quarter 2005 earnings announcements from several major banks that net interest margins shrank in recent quarters should come as no surprise to seasoned bank observers. With the federal funds rate increasing 250 basis points (bps) since the summer of 2004, time alone will expose some funding strategies' ugly side. Whether interest rates head much higher is anyone's guess, but margin shrinkage at some financial institutions is not over.

Bankers who lived through the high and volatile interest rates of the late 1970s and early 1980s clearly understand the risk of fixing asset yields for extended periods while funding with shorter-term repricing liabilities. Unfortunately, some younger managers, experienced only in a long-term declining rate environment, will have to re-learn lessons of long ago. True, money rates increased a couple hundred bps for short periods in 1989 and 1994, but the quarter-century trend from 20 percent (and more) rates has been markedly down to 40-year lows in 2004. Far from some minds are the collapse of savings and loan (S&L) margins and the estimated \$300 billion cost the government's Resolution Trust Company incurred to clean up insolvent depository institutions.

Rising interest rates, coupled with extended fixed-rate mortgage portfolios (whole loans or mortgage backed securities (MBSs)), traditionally and fundamentally lead to margin maintenance problems. The repricing characteristic of *lending long whilst funding short* creates the traditional repricing gap risks painfully experienced by the S&L industry. Many now understand this earnings problem could be tempered if funding were supplied by longer-term fixed rate funding sources, hereby reducing the repricing gap risk.

Depositories then and now have the ability to extend funding through Federal Home Loan Bank (FHLB) advances, or synthetically with pay-fixed swaps. However, capital market funding strategies are fraught with their own set of short-straddle option issues. The earnings and capital problems at the FHLB of Seattle recently exemplified this option straddle risk.

Today, however, we have an additional source of pain. Revisions to accounting rules create a new layer of performance measurement and capital adequacy issues not experienced a quarter century ago. Back then, S&Ls *managed* their way through difficult earnings and capital positions through creative account ploys available under traditional cost-based accounting regimes. As long as the S&L was perceived as marginally profitable with adequate book capital, not much attention was paid to opaque declines in asset values. But now, the prevalence of fair value accounting for large portions of the balance sheet's assets creates greater transparency of changes in values. Declines in asset values in a rising rate environment will show up in capital accounts, particularly OCI, sooner.

With interest rates being so low in the past few years, many bankers have extended the yield curve, seeking higher asset yields to maintain net interest margins. Some have found asset funding through FHLB advances to be an attractive earnings opportunity, albeit at a higher interest cost (and potential risk) when compared to funding with core deposits. Other bankers have taken the attitude that the stable nature of core deposits provides a natural risk hedge in funding longer-term assets ... at a lower cost and less risk.

With 47 percent of banking core funding coming from non-maturity deposits (NMDs) like checking and savings, many bankers have justified asset growth and term extension decisions on the long-term nature of these deposits. This justification is often supported by core deposit studies garnered from historic account data that conclude NMDs are indeed stable and