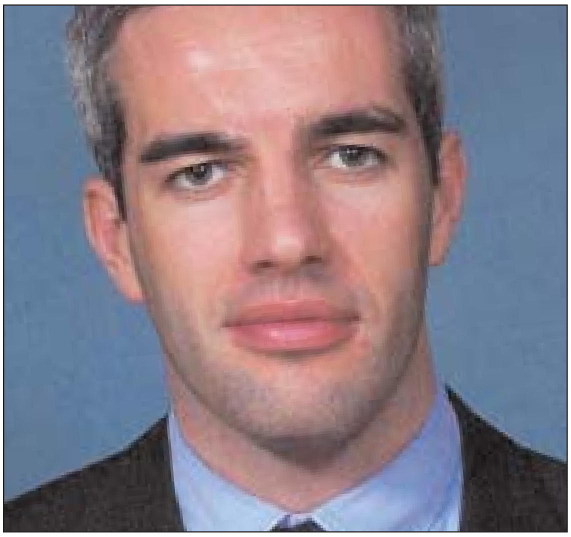
Pushing the boundaries

The introduction of IAS 39 this year has caused some corporate treasurers to rethink their use of derivatives. Banks are looking to structure derivatives solutions that achieve the economic objective of a hedge, while avoiding undue volatility on the balance sheet. But is this just a pipe dream? Duncan Wood investigates

It's nearly a year since IAS 39 came into effect, yet the new accounting rules for derivatives are still causing howls of protest from corporate derivatives users, who have to accept earnings volatility as the cost of using more complex hedging products. Banks are now testing the boundaries of IAS 39 as they look for ways to structure a new generation of products that combine risk management sophistication with favourable accounting treatment – but corporate auditors are pushing back.

"I've been presented with things that banks believe will work and I have not agreed. We're drawing the line in a different place to where the banks would like us to draw the line," says Pauline Wallace, a senior partner at PricewaterhouseCoopers' (PWC) global accounting consulting services group, in London.



The standard's basic position is that all derivatives must be marked-to-market at each accounting period, with any change in the value of the derivative booked as profit or loss. The resulting earnings volatility can be avoided if the company is able to obtain hedge accounting treatment. To qualify for hedge accounting, companies have to pair up specific derivatives with underlying exposures, and perform quantitative tests to show that the hedge has (and will continue to) offset changes in the value of the underlying item. If the hedge covers less than 80% or more than 120% of the value of the underlying exposure, it is deemed ineffective and the derivative must be reclassified as a trading position.

It's relatively easy to obtain hedge accounting for short-dated derivatives or simple swaps, but these hedges also lack flexibility and specificity. As the hedge becomes more complex, however, it gets much harder to document and maintain effectiveness. "In any hedge, there is almost always some ineffectiveness. It is the nature of the beast," says Wallace.

The standard is a lengthy, complex document, which is still under discussion – and banks are exploring some of its woollier principles in an attempt to develop products that will meet the effectiveness criteria. For example, the standard allows corporates to designate a derivative as a hedge against a portion of an underlying exposure, says Wallace. So, a company that wants to mitigate its risk on a corporate bond could decide to hedge only the exposure arising from changes in Libor. As a result, relatively simple products can be used to mitigate the risk of more complex exposures. Banks want this provision to be interpreted as loosely as possible. Auditors don't see it that way.

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"The standard explicitly allows you to hedge risks within bigger exposures, but I like to think it has to be an identifiable portion of the exposure and banks might see it more generally than that," Wallace says.

The bankers' hope is to avoid clearly identifying the underlying portion of risk that is being hedged. Rather than hedging Libor or another index, for instance, they believe that the standard should allow them to hedge a generalised portion of the exposure. If they could do that, it would be far easier to say that a derivative was effective – the exposure would be matched to the hedge, rather than matching the hedge to the exposure. So far, Wallace hasn't seen them do it "in a way that would satisfy an auditor".

Banks aren't just having trouble satisfying auditors, either. Despite persistent complaints about the standard (see box) companies are not convinced that new structures are the answer. The group treasurer with one FTSE 100 company describes IAS 39-compliant hedging as "expensive mumbo-jumbo". He says the company has invited a few banks in to its offices to present new products and solutions, "just to make sure we weren't missing out on anything. But they all grind to a halt when you ask a few penetrating questions."

IAS 39 is so restrictive, he says, that it would be "impossible" to replicate formerly-popular strategies in new hedge accounting-compliant transactions: "When I say impossible, I mean it. I'm not trying to say that it would be very difficult. I literally mean that it would be an impossibility."

Now that companies are required to carefully document and test all their hedges, there appears to be a reluctance to experiment with new, complicated products. Alain Girardeau-Montaut, head of forex risk management at France's Dassault Aviation, and president of the risk working group at the Association Française des Trésoriers d'Entreprise, says that "it seems difficult to find genuinely new products on this front. Many banks are trying to do their best with existing products because senior management at many corporates want to avoid any exotic elements inducing volatility on the profit and loss account while they get to grips with IAS 39."

Against this backdrop, some banks have decided that it's just not worth piling resources into searching for ways to beat the standard. Garrett Curran, London-based global head of derivatives marketing at Dresdner Kleinwort Wasserstein (DrKW), says: "While there may be structures that overcome the accounting hurdles set by IAS 39, we do not believe that many corporates will have much appetite for such formats – corporates have been much more cautious in testing interpretations of accounting standards in the wake of the scandals of recent years."

Other banks are sticking with it, and are employing as many accounting specialists as they can get their hands on in an attempt to ensure that their products comply with the new rules. PWC's Wallace says that some financial institutions have been making a concerted attempt to poach her staff. An accounting expert at one UK bank says that he was head-hunted within the past year while working at a national standard-setter. He adds that many banks have been transferring US-based staff to Europe in order to benefit from their experience in dealing with FAS 133, the US equivalent of IAS 39. So far, though, attempts to improve the banking industry's accounting capabilities have not paid off in the form of new blockbuster products.

It's not for want of trying. Most banks refused to comment on specific structures for this article, citing fears that competitors would steal their ideas. However, one UK institution claims to be working on a product that would combine a long-term cross-currency swap with a short-term option, allowing the end-user some flexibility when setting the swap rate. The option would expire at the start of the reporting period, meaning that it would not need to be accounted for on balance sheet. Companies would therefore be able to respond to market movements and potentially reduce their cost of funding, while still obtaining hedge accounting.

It sounds like a smart idea, but one UK bank accounting expert said that he had not yet seen any transactions that are tailored to get hedge accounting: "The reason people are clamming up is that the products are still being tested. They're just not bedded down," he says.

An illustrative story comes from one Italian construction company, which was approached by its bankers in June with a novel transaction intended to tackle one of the big gripes about IAS 39. The company has irregular but substantial foreign exchange exposure, resulting from payments made as overseas building projects are completed. Because of construction delays and disputes, the company never knows when the cash is going to arrive. It could be late, it could be early. It could even arrive in instalments. As a result, mismatches between the exposure and the hedge would be almost impossible to avoid, making hedge accounting treatment something of a pipe dream.

The bank's solution was a product that would allow the company to sell any part of an expected cashflow to the bank at an agreed price at any point over the life of the derivative. So, the contract could be struck to mature at a point well after the cashflow was supposed to materialise. If it turned up on time, the company would be covered. If part or all of it turned up late, the company would still be covered.

"It sounded too good to be true," says Michele Casò, a professor of IFRS at Milan's Bocconi University, who also advises companies on how to deal with IAS 39. The construction company – a client of his – had contacted him excitedly to get his opinion on the deal they had been offered. Caso was sceptical.

"It appeared to be like a combination of a US call option and a US put option. It would allow you to settle at any point in time, but with the additional feature that you could also do partial settlement."

Caso suspected the rub might lie in the fact that, after a partial settlement, the contract would be re-priced – the bank would still buy the rest of the currency at the agreed amount, but the final settlement price would be adjusted. He asked for more specific details about the product. Four months later, nothing has materialised.

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A more prosaic response to IAS 39 has been to split a complex hedging product into two legs. One leg is the hedge and can qualify for hedge accounting treatment more easily, while the other leg is the performance-related part of the product. "Transacted together, the product would not obtain hedge accounting and all mark-to-market changes would appear as profit and loss. Transacted separately, at least one leg of the product has a chance to qualify for hedge accounting," says Christelle Lefebvre, equities and derivatives structurer at BNP Paribas in Paris.

HSH Nordbank has adopted the same technique to make complex hedging products easier for its corporate clients to swallow, says Philipp Niesing, a Kiel-based relationship manager with the bank's capital markets sales group. As an example, he cites a participating forward, in which a normal forward purchase of a foreign currency is combined with an option, allowing the end-user to benefit if the cost of the purchase falls in the intervening period. The combined product is unlikely to achieve hedge accounting treatment, but splitting it into its component parts enables the impact to be minimised.

However, the complexity of the standard, coupled with concerns about hedge accounting, has meant companies have been cutting sales calls short, says Niesing. Among mid-cap companies in particular, "treasurers often come from a book-keeping background, so they're very much focused on the effect that derivatives could have on the balance sheet", he says.

This kind of response isn't limited to smaller companies. Pierre Savu, head of IFRS and accounting advisory at French investment bank Calyon, says that even more savvy treasurers at big companies are shying away from transactions that don't get hedge accounting.

"Our usual entry point at the Cac 40 companies we deal with for derivatives products is the chief treasurer, and our derivatives sales force is often being told that there is a lot of resistance to these trades at the chief financial officer level. The treasurers are being told that the company doesn't want extra volatility in its accounts."

There's something vaguely ironic about companies rejecting hedging transactions on the grounds of increased volatility of earnings when the whole point of hedging is to produce more stable earnings. In essence, companies seem to be more tolerant of volatility arising from their operations than they are of volatility in the way those operations are represented in their accounts. DrKW's Curran agrees: "In many cases, the tail is wagging the dog. Rather than trying to manage their economic risk, many companies feel forced towards looking at how any instrument that might hedge risk will be accounted for."

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As such, some banks are focusing less on trying to develop new products than on helping companies understand how to reconcile the economics of existing products with IAS 39. Calyon's Savu says he hopes that companies can be "educated about the constraints of the standard so that they are able to continue managing risk effectively while simultaneously avoiding undue volatility in their accounts, for example through a clever use of hedge accounting". DrKW's Curran says that one of the bank's aims is to "convince clients that their shareholders' interests are best served by accepting some accounting volatility".

That's certainly the view of the FTSE 100 company's group treasurer. His company decided that it would try to obtain hedge accounting only where it was easy. "Where it's difficult to get, we won't bother. We're not interested in participating in a hedge accounting competition. It won't stop us doing something that we think we need to do."

If more companies come round to this way of thinking, the quest for IAS 39- compliant hedges may become unnecessary. But DrKW's Curran warns that this kind of consensus in the corporate world is unlikely to emerge any time soon. In his opinion, companies are worried about volatility arising from mark-to-market changes in their hedging positions simply because it's harder to explain to the investment community than volatility arising from a change in interest rates or a fall in the value of the dollar.

"Until equity analysts begin to embrace a more rigorous approach to corporate valuation, which gives proper credit for good risk management, corporate treasurers and finance directors will see derivatives-related accounting volatility as sufficient disincentive to embrace a more holistic approach to financial risk management," he says. ■

Gripes continue over IAS 39

Two months from now, companies will be working on their first set of full-year reports using IAS 39. There will almost certainly be a fresh spike in criticism of the standard at this time, as companies who feel that their results have been distorted by the standard make their feelings known. To some observers, this is all a normal part of IAS 39's growing pains. Given time, they argue, companies will come to understand the new rules better and the controversies will fade.

There was some evidence of this process in a survey released by Ernst & Young and the Association of Corporate Treasurers in September. Asked whether they believed that IAS 39 provided financial statement users with a better picture of the risks involved in corporate treasury operations, 43% of respondents agreed, or strongly agreed. Last year, that figure was only 26%. The 2004 survey also showed that 87% of respondents felt that IAS 39 would have a material impact on their financial statements. This year, that figure had fallen to 49%.

On the face of it, this seems to suggest that the standard's implementation has not lived up to companies' worst fears. More companies feel that the standard paints an accurate picture of risk; fewer companies expect it to have a material impact on their results.

But this impression of a corporate world that is coming to terms with IAS 39 ignores the fact that many companies still have fundamental objections to the standard and, in some cases, these objections are actually on the rise. For example, 67% of respondents now believe that IAS 39 will cause increased volatility in financial statements and key financial ratios. In 2004, a majority of respondents had answered that they didn't know whether volatility would increase.

Surveys are good at providing a broad-brush impression of sentiment. However, comments made by individual companies can be far more pointed. The group treasurer of one FTSE 100 company remains convinced that the standard is "incoherent" and has not been properly thought through.

While preparing for IAS 39, the company examined how the standard would affect its foreign currency borrowings: the firm works on long-term overseas projects and tries to ensure that its working capital in each country is financed by debt in that country's local currency. "We feel that shareholders are happy to accept some financial leverage. We don't think they want added foreign exchange risk on top of that," says the treasurer.

There are a number of ways to execute this policy, he says – for example, by obtaining bank loans in each country, or by borrowing in the UK and swapping it into the required foreign currencies. The company picked five different strategies in order to assess the impact of IAS 39 (none of them called for anything more complicated than a combination of a loan or a bond combined with a currency swap or an interest rate swap) and used the base example of a US dollar borrowing requirement worth £400 million and fixed assets also worth £400 million. The accounting treatment for each strategy was calculated under a single scenario for forex and interest rates.

Under existing UK accounting rules, all five strategies would have produced the same result – a net liability of £40 million. There would be no impact on profits. Under IAS 39, the size of the liability varied from £28 million to £62 million, depending on which strategy was used and whether hedge accounting was obtainable. The impact on profit and loss ranged from a gain of £12 million to a loss of £62 million. The company also asked Deloitte & Touche and PricewaterhouseCoopers to do the same calculations. The auditors disagreed with each other for three of the five possible strategies.

At this point, the treasurer says, "we decided that this was all a load of nonsense and said that we were just going to focus on the economics and, whatever accounting treatment resulted, we'd just have to explain it to our investors". ■