IFRS 9 hedge accounting: time is running out for compliance

Lessons learnt from early adopters

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Content

Executive summary

The treasury community waited a long time for changes in international accounting standards that make hedge accounting less complicated and more in line with risk management activities. IFRS 9 was issued in its entirety in July 2014, and the regulatory deadline is 1 January, 2018. Organizations exposed to market risk can no longer be complacent about carrying out an IFRS 9 compliance project. These projects take time and come along with technology investments. They require a solid business case that successfully articulates the benefits and the requirements of adoption.

This white paper gives finance teams an express track to compliance. Based on the experience of early adopters around the world, the information here will provide teams with the practical information – and the inspiration - they need to act now.

Introduction

IFRS 9: Financial Instruments is replacing International Accounting Standard (IAS) 39: Financial Instruments - Recognition and Measurement. The new standard was issued in its entirety in July 2014 and will come into effect for periods beginning on or after 1 January 2018. With early adoption having taken place in jurisdictions where permitted, finance teams can now take advantage of lessons learnt from early adopters. Additionally, they can use an IFRS 9 compliance project as an opportunity to understand how to better manage their financial risk and deliver ROI.

This white paper tackles IFRS 9 implementation in two parts. First, the top lessons learnt by companies that have forged ahead with early adoption:

1. IFRS 9 implementation projects take time
2. Not all treasury management systems support the new standard equally
3. The ROI of new hedging strategies and updated risk management programs can be significant

The second part of this white paper examines more deeply the following key advantages embedded in IFRS 9:

About Reval

Reval is a global SaaS provider for Treasury and Risk Management, helping enterprises better manage cash, liquidity and financial risk, and account for and report on complex financial instruments and hedging activities.

Our Hedge Accounting Technical Taskforce (HATT) helps finance professionals with practical guidance and insight into upcoming regulatory changes.

For more information, visit www.reval.com or email info@reval.com.

1. Hedging instruments – option time value
2. Hedging instruments – currency basis on CCIRS
3. Hedged item – component hedging of commodity risk
4. Hedged item – derivatives as hedged items

Compared to the incumbent IAS 39 accounting standard, the changes in IFRS 9 are vast and significant. They were devised primarily in response to criticism of the current rules and feedback on how they could be improved. Given the IASB have followed through with many of the suggestions of their constituents, the accounting will be much more aligned with risk management and the economic activities of organizations.

Part I – Lessons learnt from early adopters

Early adoption of IFRS 9 was possible in Australia, Japan, India, Switzerland, South Africa, and Canada. Companies in those counties are already seeing benefits such as reduced P&L volatility and better risk management. Here are key takeaways from those projects:

Key lesson #1: IFRS 9 implementation projects take time

In a recent Reval survey, almost 70% of respondents said they are considering or have already entered into new hedging strategies because of the new standard. To achieve this, various stakeholders including treasury, financial reporting, accounting policy, tax, internal and external auditors, global production, other companies within the group, and investor relations need to be involved and informed.

As IFRS 9 is a drastic hedge accounting change that needs to be coordinated across the enterprise, implementation projects take between 9 and 18 months. Within that range, the implementation time varies, depending on the complexity of the portfolio and the company's appetite for new hedging strategies. In some instances, retrospective application is required. So, starting the IFRS 9 project in time is of essence.

Key lesson #2: Not all treasury management systems support the new standard equally

As corporations transition to IFRS 9, they not only review their hedge accounting policies and processes, but also their technology stack. As not all treasury management systems support IFRS equally, early adopters share some tough questions that IFRS 9 project managers should ask their treasury technology providers:

- Do you have domain experts that can support me in hedge accounting and risk management?
- Do you offer comparative analysis between IAS 39 and IFRS 9 accounting?
- Have you worked with Big 4 auditors and consultants to develop your system's IFRS 9 capabilities?
- Are you working with clients to implement best practice functionality for complying with the new standard?
- What IFRS 9 capabilities are available in your treasury system today?
- Can you show me your product roadmap to give me an idea when IFRS 9 will be fully supported in your treasury software?
- What is the cost of your IFRS 9 capabilities? What is the average spend on IFRS 9 implementation projects?
- Can you provide me with a sample IFRS 9 implementation plan?
- Do you have customers that are already using or testing the new IFRS 9 functionality?
- What are the main benefits your customers are seeing from early adopting IFRS 9?

Key lesson #3: The ROI of new hedging strategies and updated risk management programs can be significant

Just like any other significant project, treasury and finance departments must present a strong business case for change. The transition to IFRS 9 comes at a cost in terms of training, process change and, very importantly, technology change as a start. Potentially there is also the cost of changing hedging strategies, and therefore, risk management policies. The best business cases tend to include a Return on Investment (ROI) analysis – a selection of tangible and intangible benefits an organization is likely to achieve through the adoption of this standard.

Early adopters have seen benefits in two core categories:

- **Reduced P&L volatility** – Given current hedge accounting activities, how much less P&L volatility can be expected to incur as a result of adoption. In addition, to which hedges could you now apply hedge accounting, and thus, where could P&L volatility be reduced.
- **Better managed risk** – Which different hedge accounting strategies can be deployed to better meet the risk management objectives of the company and still meet the hedge accounting criteria laid out under IFRS 9.

Part II – Key advantages in IFRS 9 and return on investment

Early adopters of IFRS 9 have achieved significant benefits from reduced P&L volatility and better risk management. The second part of this white paper will examine potential ROI from both of these perspectives for each of the following key advantages embedded in IFRS 9:

1. Hedging instruments – option time value
2. Hedging instruments – currency basis on CCIRS
3. Hedged item – component hedging of commodity risk
4. Hedged item – derivatives as hedged items

These four areas cover 95% of corporate hedge accounting needs under the new standard.

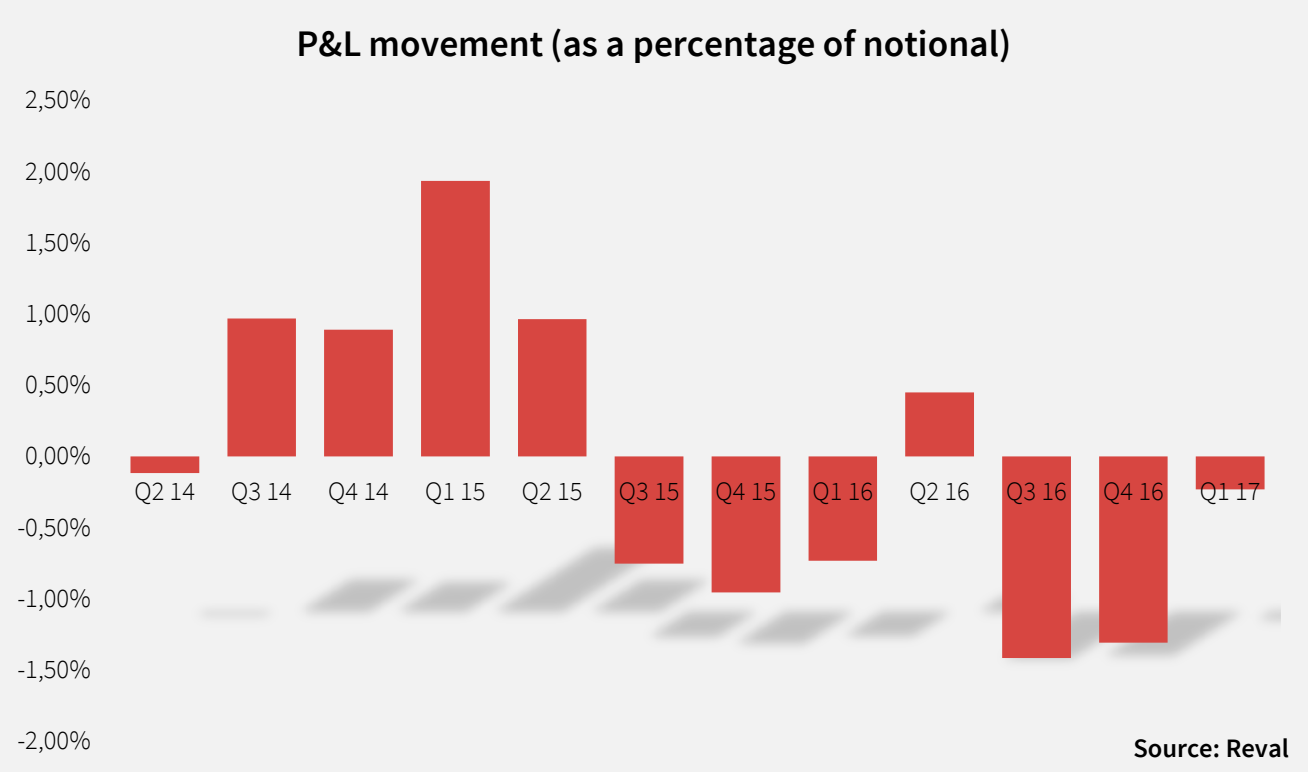
Advantage #1: Hedging instruments – option time value

Guidance: Para 6.5.15 b) allows for changes in time value of an option to be recognized in Other Comprehensive Income (OCI). - This contrasts to the current guidance under IAS 39, in which movements in time value flow through to P&L.

ROI – Reduced P&L volatility

There is clear ROI here as this new guidance allows what used to be recorded through P&L to now be taken to OCI. But how do you best determine the level of ROI? While you cannot predict future P&L volatility arising on time value, you can look at previous movements in time value over a period of time. Look at the amount of P&L volatility generated over the last three years and reported in the

financial statements. If this is not easily identified, you can consider typical option positions held by the business in the past, and back test the time value movements that must have impacted your P&L over that time. For example, consider EUR/USD put option @ 1.10 for 100m EUR – the time value movements back tested over the last 12 quarters would be as follows:



In this analysis, we can see swings of nearly $2m (or 2% of notional value) simply due to time value. This would have to be taken to P&L under IAS 39 but on a perfectly aligned exposure under IFRS 9, all of this time value would be deferred to OCI. Compare this P&L swing to your EBITDA values - in ROI terms, adoption of IFRS 9 would remove this volatility from the reporting profits.

ROI – Better managed risk

Ever since IAS 39 rules meant that option time value would move through the P&L, many companies either reduced their option-held positions, never held options over a reporting period or stopped trading options altogether. Here we have accounting rules having an undue influence over risk management decisions and one of the key issues the IASB was looking to overcome with the introduction of IFRS 9.

A detailed measure of the potential ROI here is to back-test what would have happened had you deployed a greater level of option-based hedging over the past two years, compared to your actual hedging strategy over that same period. Beware that this can be a lengthy exercise and involve a number of assumptions. Tools such as Cash Flow at Risk can significantly help with this analysis.

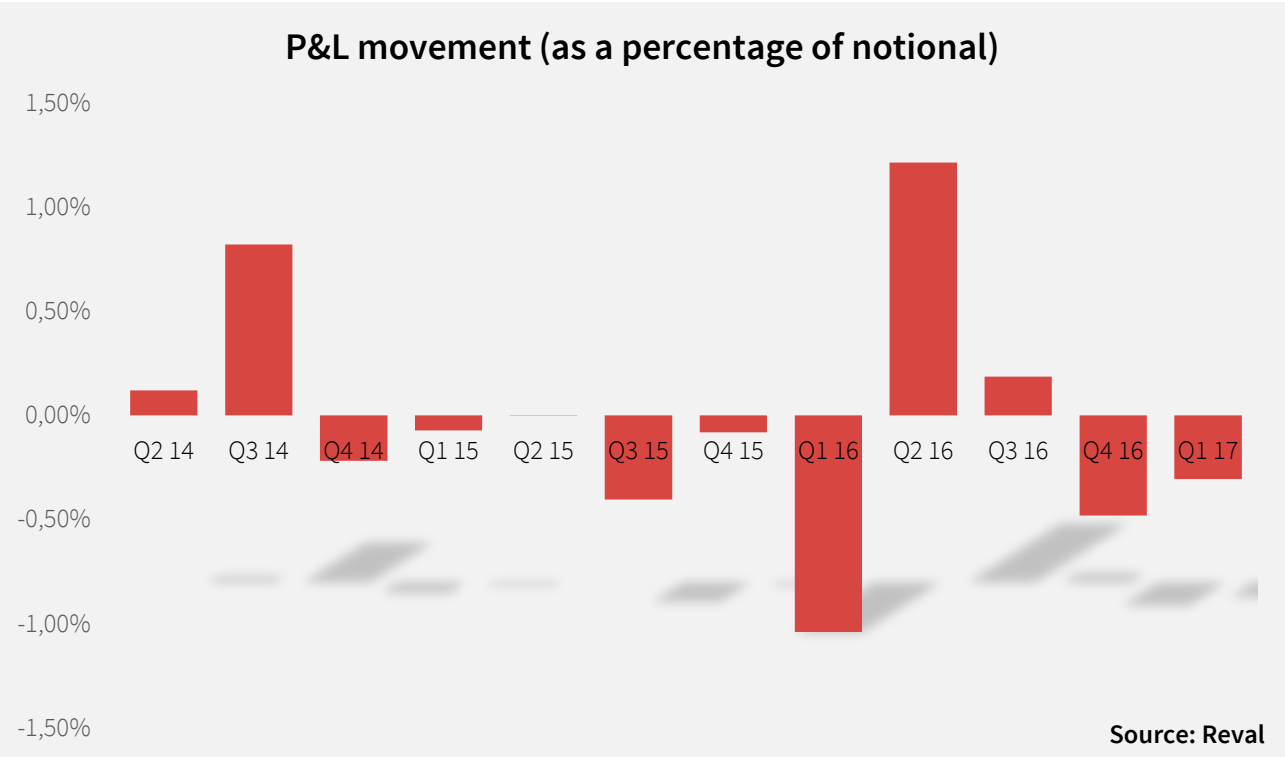
An alternative, more holistic ROI is to simply highlight that accounting will no longer drive the decisions around when and to what level an option-based hedging strategy should be applied.

Advantage #2: Hedging instruments – currency basis on CCIRS

Guidance: Para 6.5.16 extends the application of option time value highlighted above to the forward element on forward contracts and foreign currency basis spread on fx forwards and cross currency interest rate swaps ("CCIRS"). Currency basis has typically caused P&L volatility under the current guidance for Fixed to Float CCIRS, particularly since the financial crisis when basis spreads became a lot more volatile. This new guidance effectively allows these movements to be deferred into OCI.

ROI – Reduced P&L volatility

Similar to option time value, a simple back test on the movements in currency basis over an historical time period can be a good estimate of future value of adopting IFRS 9 in relation to currency basis. For example, if we consider a USD/HKD CCIRS for $100m USD which swaps fixed USD Debt to synthetic floating HKD-based debt - the currency basis movements back tested over the last 12 quarters would be as follows:



In this analysis, we can see swings of up to nearly 1.5% of debt notional due to movements in currency basis. For fixed to floating CCIRS, this movement would typically have been taken to P&L under IAS 39 and potentially even caused some hedges to fail but under IFRS 9, all such currency basis would be deferred to OCI to the extent the hedge is effective. As with option time value, compare this potential P&L volatility to your EBITDA levels - in ROI terms, adoption of IFRS 9 would remove this volatility from the reporting profits.

ROI – Better managed risk

Protecting offshore debt positions against adverse currency movements usually is applied with CCIRS regardless of the accounting consequences, so we see less application for ROI here around better risk management.

Advantage #3: Hedged item – component hedging of commodity risk

Guidance: Para 6.3.7 opens up the definition of risk components available for designation to include non-financial items, as long as they are "separately identifiable and reliably measurable". - Component hedging was not allowed under IAS 39 for non-financial items (most commonly commodities) and often

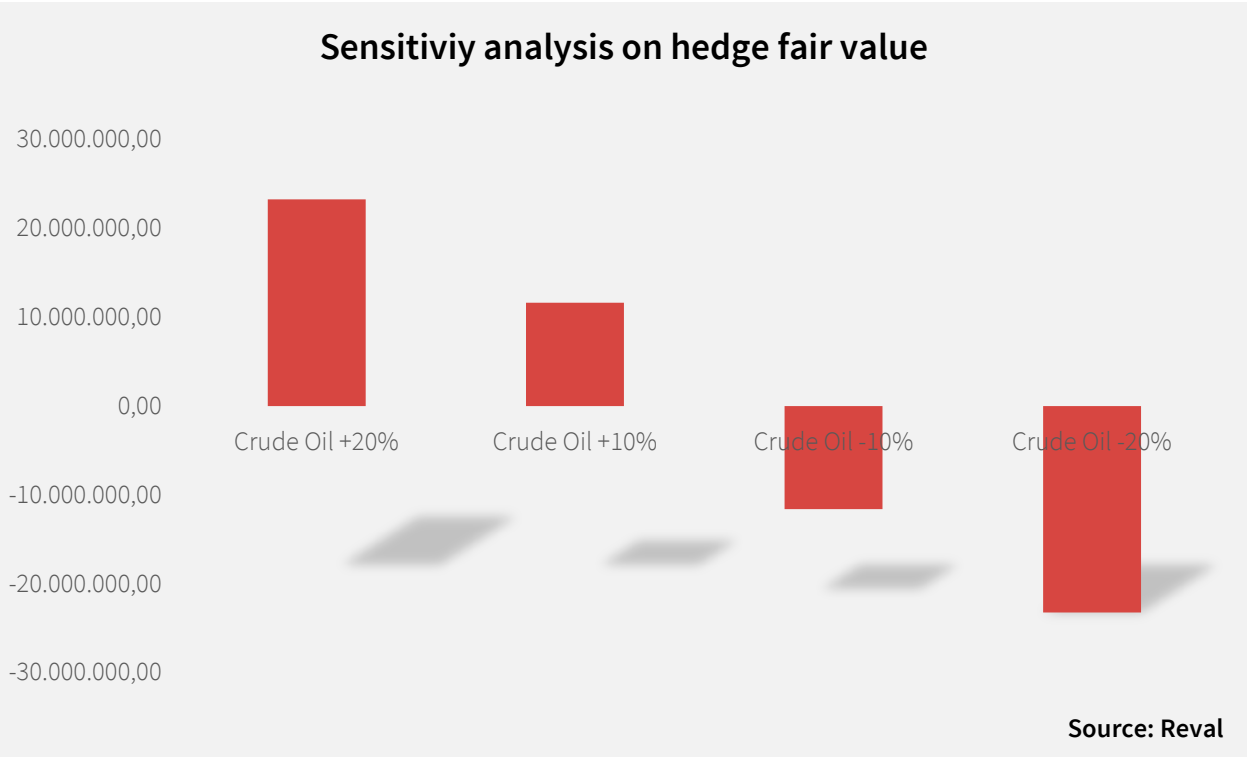
resulted in hedge ineffectiveness, or no hedge accounting at all being applied on. This new guidance allows much greater flexibility in the way companies can define their hedged items such that hedges will be more effective in offsetting the hedged risk. You may now be able to hedge the rubber component of a tire, the aluminium in a can, the crude component of jet fuel etc.

ROI – Reduced P&L volatility

Hedge ineffectiveness for commodities under IAS 39 often arises from the unhedgable component of the exposure – the processing element to turn it into a usable good, the location of the commodity, the freight cost and so on. While some of these costs are not predictable, looking at past ineffectiveness can give a clear indication of likely future savings since IFRS 9 often allows these components to be excluded from the hedge relationship. Finance departments should be able to provide reported hedge ineffectiveness over the past years resulting from commodity basis risk.

A secondary point may be hedges that never had hedge accounting applied to them because of the restrictive rules in force in IAS 39. If such hedges would now qualify given the new criteria in IFRS 9, all of that potential fair value could be deferred to OCI. A good way to measure this potential ROI is to consider sensitivity analysis on market rate movements based on your typical hedge levels – this is an indicator of the potential P&L volatility that could be avoided if IFRS 9 was applied.

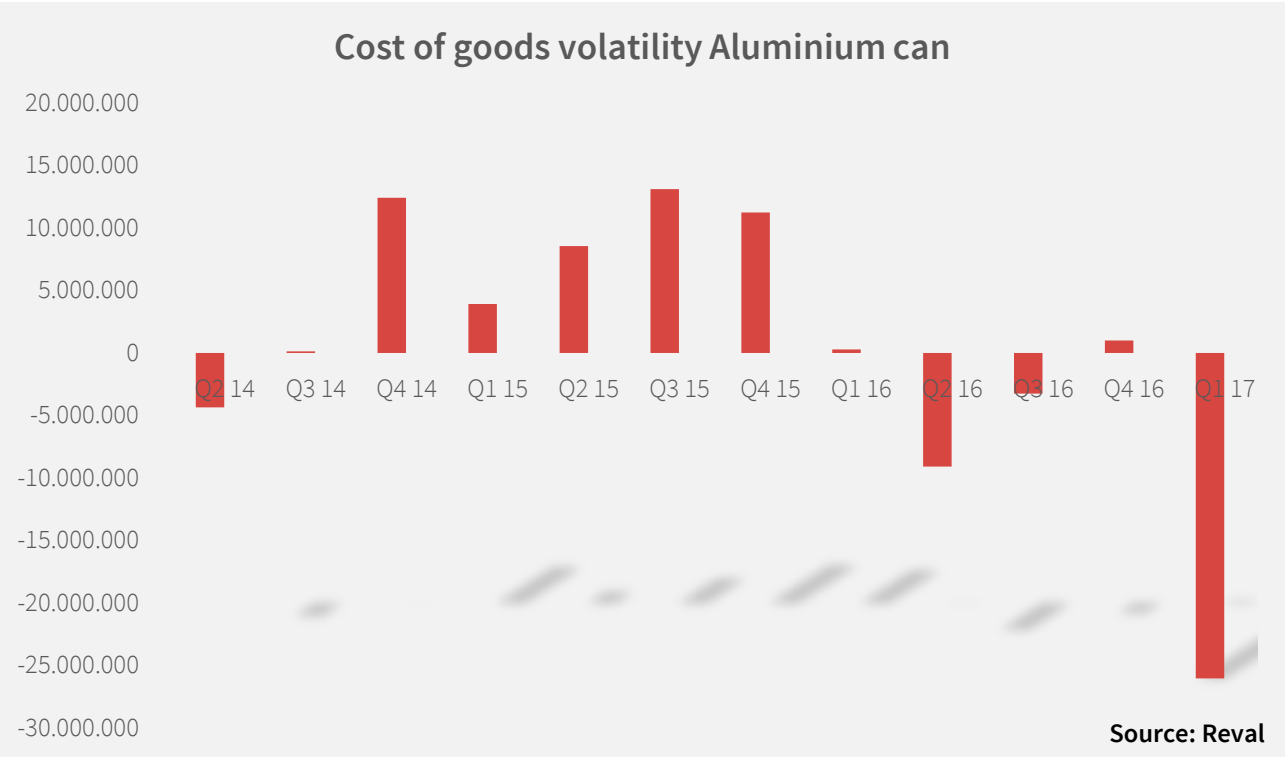
The following graph shows an example where a crude oil hedge position was stressed for +- 10 and 20 percent movements in the crude oil price. For a significant position such as this, the company was exposed to a $23 million USD hit to P&L for a 20% movement down in price.



ROI – Better managed risk

Many organizations have shied away from hedging commodity risks because of the difficulties of successfully applying hedge accounting under the current rules. A good ROI analysis to again consider back testing is to look at how much price volatility the company experienced without a commodity hedging program in place.

Consider, for instance, a company that consumes aluminium cans in its production line. A large portion of the costs is associated with the price of aluminium; however, the company has never hedged as it could not be assured that hedge accounting was achievable under IAS 39. The graph below illustrates the P&L volatility experienced over the last 12 quarters in USD, a large portion of which could have been eliminated with a hedging program in place.



With an early adoption of IFRS 9, such a company could implement an aluminium hedging strategy with the confidence that hedge accounting could be successfully applied. This can be a key ROI benefit for many organizations looking at this potential new hedging strategy. Companies in this sector will be clearly able to differentiate amongst their competitors and significantly change the bottom-line results.

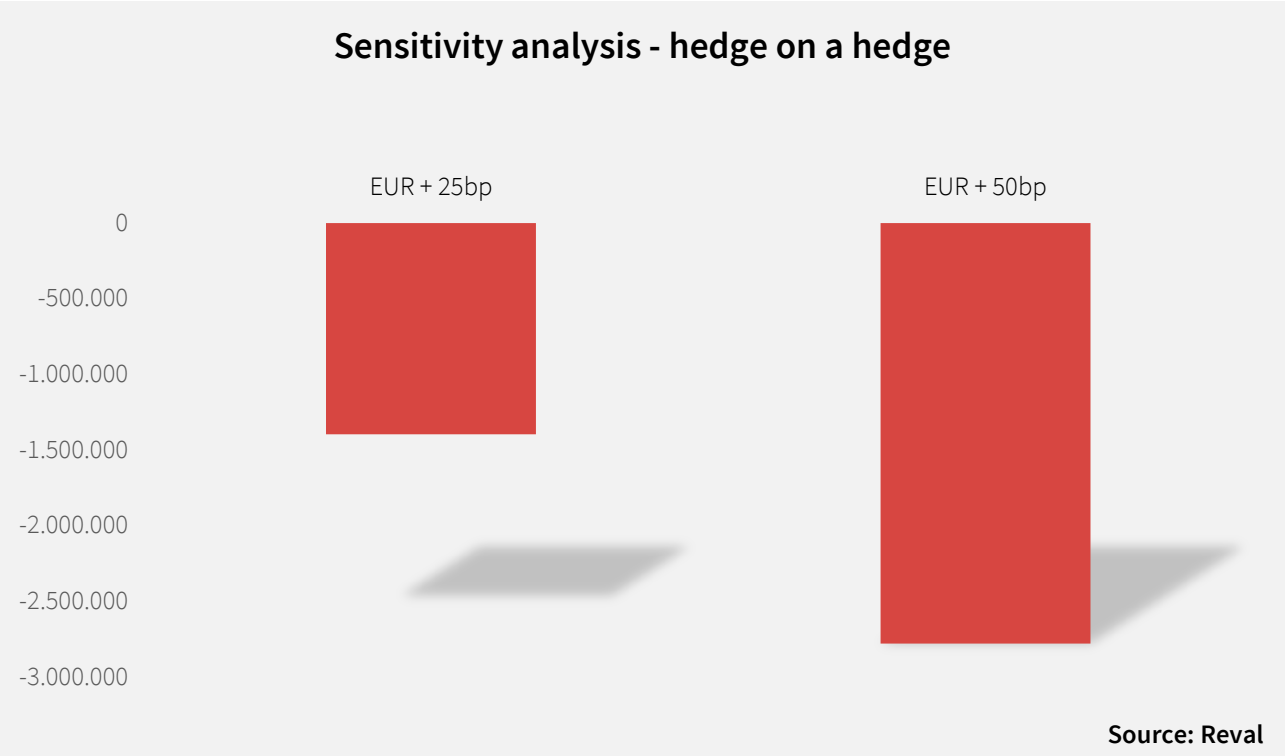
Many companies are also looking to transfer the management of commodity risk from procurement into the treasury department which will also increase the potential for financial hedging of commodity price risk.

Advantage #4: Hedged item – derivatives as hedged items

Guidance: Para 6.3.4 allows for a new concept whereby a non-derivative can be combined with one or more derivatives as an aggregated exposure for hedge accounting. Derivatives were never allowed as hedged items under the current guidance so this change brings more flexibility and is another example where the accounting will now more closely match how organizations manage their economic risk.

ROI – Reduced P&L volatility

Since derivatives could never be used as hedged items previously, the most likely source of ROI on existing hedging strategies is avoiding the mark-to-market on hedges of aggregated exposures that now currently flow through P&L. For instance, you may have some overlay interest rate swaps hedging a combined offshore debt and CCIRS position to which you are not currently applying hedge accounting. Once again, a stress test on potential interest rate movements for year-end positions is a good indicator of the levels of P&L volatility that could be avoided with early adoption of IFRS 9. Consider a Eur100m interest rate swap hedging an offshore debt combined with a CCIRS position. A stress test of fair values based on upward movements of 25 and 50 basis points is shown in the graph below:



If you foresee a tightening of monetary policy in the coming financial year akin to these types of stresses, this represents a strong ROI to apply this section of the standard.

ROI – Better managed risk

Perhaps it is with better risk management that even greater potential ROI is possible when considering derivatives as hedged items. This ruling allows treasurers to consider a more active risk management program beyond the 'set and forget' type hedging strategies they may have used in the past. At the

simplest end, you may have an offshore debt and CCIRS position in which you are paying floating rate in your functional currency. If you want to fix some of the interest rate risk, you can enter into an interest rate swap to convert the synthetic floating rate risk on the debt/CCIRS combination to fixed interest cash flows. Now under IFRS 9, that transaction is hedge accountable since you can designate the debt and CCIRS together as a hedged item. Further on, you may want to convert even more of the exposure to fixed using the same approach or even convert the fixed cash flows back to floating at a later date – all transactions could be hedge accounted under IFRS 9 but were specifically disallowed under IAS 39. The ROI here is clearly greater flexibility in your hedging activity.

Further, the ROI can be even more transformational. Consider the scenario where an organization uses collar option structures to hedge their FX risk. Many organizations find that as the market moves, some of the strikes on their option protection can be so far out-of-the-money that they offer little further protection given current market circumstances. By layering a more 'dynamic' hedging strategy in which strike prices are adjusted over time depending on the delta position of each option, companies can improve their protection levels. This type of hedging strategy can be hedge accounted using the 'derivatives as hedged items' ruling of Para 6.3.4 as long as at no point, do the options constitute a 'net written option'. This would represent another significant opportunity for treasurers to better manage their risk profile under IFRS 9.

These ROI examples on the most commonly applied aspects of IFRS 9 have been used by early adopters in successful business cases. However, there are many more advantages such as hedging instrument combinations, the rebalancing mechanism, net position hedging, or hedging with structured products that could provide additional advantages to your company and should be considered.

You should also consider the additional disclosure requirements under this standard, which bring a much greater level of transparency around risk management objectives and activities to help users interpret the new financial outcomes.

Now is the time to act

There are many advantages in IFRS 9 when compared with the current standard, IAS 39. Those treasurers looking to protect the balance sheet may be looking at adding new commodity hedging or overlaying interest rate swaps on existing CCIRS positions and designating them in hedge relationships. The finance team will take notice at potential P&L volatility reductions on option time value, currency basis, and commodity hedging. Others may be looking at their competitors and eyeing up opportunities to bring more upside in their hedging portfolio utilizing vanilla or structured option products or by building out more dynamic hedging strategies. The key here is to take these technical concepts and evolve them into a robust and measurable ROI that senior management and the board can act upon – now.