Why Hedge Accounting?

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In a year where central banks continue to hike interest rates and tighten financial conditions to counter inflationary pressure, interest rates across the yield curve have increased significantly. Locally, interest rates have soared more than 500% since January on the back of monetary tightening and factors linked to local liquidity. This is also a year where major currencies have witnessed a pick-up in trading activity amid an increase in market volatility as gauged by several implied FX volatility indices. At the same time, high commodity prices went hand in hand with the threat of major supply disruptions. That, in turn, has intensified global inflationary pressures and contributed to genuine fears of worldwide recessions.

With uncertain and volatile markets, hedge activities tend to increase, but the overall numbers seem to be mixed. According to the Bank for International Settlements (BIS) triennial central bank survey that was issued this year, turnover in single currency OTC interest rate derivatives has declined by 19%, while OTC FX derivatives have increased by around 17%. According to the BIS, the most significant factor contributing to the decline in OTC interest rate derivatives turnover is the continuing shift away from Libor for major currencies. On the other hand, we have locally witnessed growth in hedge activities this year among corporates, in particular interest rates, despite the elevated cost of hedging. This is happening at a time when the five-year swap rate (exchanging floating for fixed cash flows) is above its five-year average by more than 60%. The cost of carry (the difference between the five-year swap rate and three months SAIBOR) is negative and off its five-year average by more than 150 basis points as of the time of writing.

Entities whom we manage to approach come with two major concerns in mind; Are we hedging at a relatively high cost? And will we be penalized once prices and markets revert or stabilize? Certainly, these are two difficult questions, and addressing them would require some fundamental understanding of the reasons behind hedging in the first place. To tackle the first concern, an entity needs to be cognizant of its risk profile as well as appetite, the available tools to manage risk, and the financial risk management objectives that would enable it to answer this tricky question of cost/benefit. As for the second concern, an entity ought to be aware of the economic and accounting implications of dealing with financial derivatives. As we approach yearend closing, the rest of this bulletin will focus more on derivatives accounting, its objectives & models, and why this topic is more relevant now than ever.

HEDGE ACCOUNTING

As part of their day-to-day business, entities are inherently exposed to different financial risks. Some entities might be concerned about exchange rates or interest rates, while others might be concerned about commodity prices. To manage these risks, entities employ different risk management strategies, some of which entail using financial derivatives.

Financial derivatives are commonly perceived as a complex topic, and the accounting of them is typically no different. By default, any derivative would have to be recognized in the Balance Sheet at its "fair value" (a.k.a. "mark to market") and its changes in the Income Statement. It is important to note that hedge accounting is not mandatory, and entities need to elect to apply hedge accounting.

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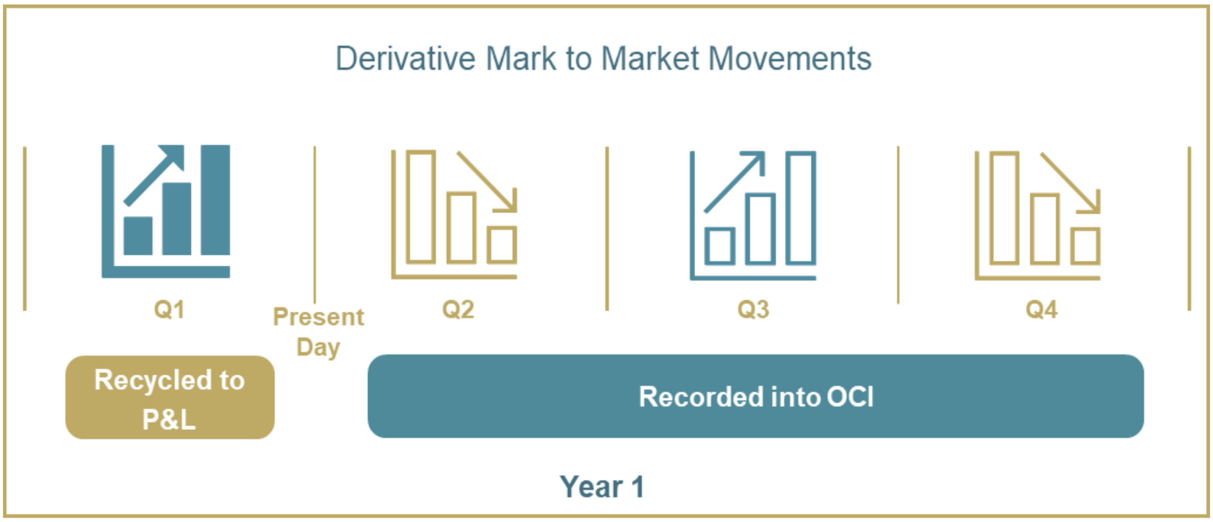
Hedge accounting is a matching concept that adjusts the normal basis for recognizing gains and losses (or income and expenses) on associated hedging instruments (the derivative) and hedged items (the hedged transaction), so that both are recognized in P&L (or OCI) in the same accounting period. The objective of such an adjustment is to represent the effect of risk management activities that employs financial derivatives in a way that mitigates period-to-period earnings volatility. Under IFRS, there are three main accounting standards that relate to derivatives: IFRS 9, which describes how to account for derivatives and apply hedge accounting; IFRS 13, describes how to determine the fair value for accounting purposes, and it would include in practice the consideration of non-performance risk (i.e., credit risk, via CVA/DVA, "BCVA") in valuations. Additionally, IFRS 7, that describes the required qualitative and quantitative disclosures. The three main hedge accounting models under IFRS 9 (previously within IAS 39 – please watch our webinar for more details) are summarized below.

Fair Value Hedge: The risk being hedged here is a change in the fair value of an asset or liability. This may also include an unrecognized firm commitment that can be attributed to a particular risk that could affect an entity P&L. In this model, the derivative and the hedged item gains and losses offset each other and are both recognized in P&L.

Net Investment Hedge: This model is a bit specific, and it is designed for a parent entity with overseas subsidiaries and operations dominated in non-functional currencies. The idea here is to hedge the currency risk associated with the translation of these foreign operations in OCI in a manner that is consistent with the reporting of the cumulative translation adjustments.

Cash Flow Hedge: By far the most popular model. The target being hedged here is the variability in cash flows that can be attributed to a particular risk and could affect an entity's P&L. Cash flows can be related to existing assets or liabilities, firm commitments, or highly probable forecast transactions. In a cash flow hedge, gains and losses on the derivative can be stored in OCI and recycled into P&L simultaneously as the hedged transaction is recorded. The below graph illustrates the way cash flow hedge accounting works and how it may spare an entity's P&L from derivatives fair value changes.



In the last couple of years, we covered numerous mandates of cash flow hedges, whether the hedged transaction is a future interest payment on a floating debt or future cash flows that are associated with a forecast sale or purchase in a foreign currency. To give you a factual example, when COVID 19 swept our world, local interest rates dropped by more than 50% in one fiscal year. As a result, an avalanche of unfavorable and extreme mark-to-market movements have struck several entities who, at the time, fixed their floating interest payments cash flows via eligible derivatives.

As mentioned earlier, these movements would have, by default, impacted their periodic earnings materially. In some cases, we are talking about derivatives revaluation losses that flipped an entity's bottom line from net profits to losses. Yet, the situation for entities that applied hedge accounting was drastically different. The minute these hedges were deemed effective, such a negative impact on earnings had been lessened from an accounting perspective. The same could be said this year for entities with foreign exchange hedges against the US Dollar or SAR that have deteriorated in the wake of a relentlessly strengthened greenback (the US Dollar index has increased more than 15% against other key currencies this year).

WHY IS IT RELEVANT NOW

With a global economic outlook that is fraught with uncertainty and markets that can be classified as unstable, it would be difficult to predict the trajectory of prices across the different asset classes in the next year or two. Picking interest rates for instance, it is not clear how long will this normalization cycle will continue and at what stage will central banks start considering expansionary policies. In other words, when will rates start to fall, and if so, at what speed will this happen?

Price instability and the degree of implied volatility in an asset class has a direct impact on financial derivatives valuations. To continue with interest rate derivatives as an example, assume that an entity today has executed a five-year SAR 100mn bullet interest rate swap transaction. Driven by its risk management objectives, the entity intends to fix the variability in its future floating interest rate payments and, thus, has decided to execute the swap. The value of the swap (mark-to-market) at execution is hypothetically close to zero. Nevertheless, a subsequent 50-basis point shift (0.5%) up or down in the forward curve will impact the entity's derivative fair value revaluation adjustments at their next earnings report by around SAR 2mn. To put this shift into perspective, the Saudi Riyal forward curve has moved more than 150 basis points just this year alone. Similarly, sharp movements in volatility levels, as observed this year, have a direct impact on the valuation of option-based derivatives.

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The purpose of hedge accounting is to shield earnings from these variabilities and not to penalize an entity for making this sensible risk management decision. As per IFRS 9, If the derivative instrument meets the eligibility standards, then it can be designated as such, provided that it would continue to meet the hedge accounting criteria. The standards would basically require establishing an economic relationship between the instrument and the hedged item. This would mean that critical terms (i.e., underlying, time horizon, commercial terms, etc.) would have to match.

It also requires assessing the effect of credit risk that can influence changes in the hedge instrument's fair value and aligning hedge accounting with risk management objectives as they relate to the desired hedge ratio. These requirements need to be tested quantitatively and qualitatively by which any ineffectiveness will have to be recorded in P&L. An entity starting point to initiate this accounting journey would have to be post identifying the risk that is currently impacting earnings. Once that risk has been identified and subsequently hedged, then an entity would have to designate the hedge by means of formal documentation. Such documentation should specify the entity risk management strategy, hedging instrument, nature of risk being hedged (hedged item), and the methodology of which effectiveness testing (sources of ineffectiveness and hedge ratio to be disclosed) will be conducted. Should the hedge be deemed effective, and ineffectiveness, if any, had been accurately measured, then what remains are IFRS 7 required disclosures.

At this point, the hedge accounting process is completed. It is worth noting, though, that Ineffectiveness testing is a continuous exercise seeing that the hedge is still active and continues to meet IFRS 9 requirements. Should that not be the case, then discontinuation of hedge accounting becomes necessary. The frequency of such assessments should be in tandem with the entity reporting requirements. Hedge accounting may seem complicated at the beginning, but in practice, it is easier than what one may expect. This is especially true in straightforward cases where the relationships can simply be determined between the hedge instrument and the hedged item. Once an entity develops this exercise internally, it becomes a routine process thereafter. I believe it is a journey worth exploring, one that would better represent entities' risk management activities and, at the same time, reduce their income statement volatility. Wishing you a smooth yearend closing!

For more information, please contact Faisal AlJasir, Co-Managing Partner at Ehata Financial, ***faisal.aljasir@ehata.com.sa****.* *You can also read the article from the website* ***here.***

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