Expect *the* UNEXPECTED

Coordinating your hedging strategies

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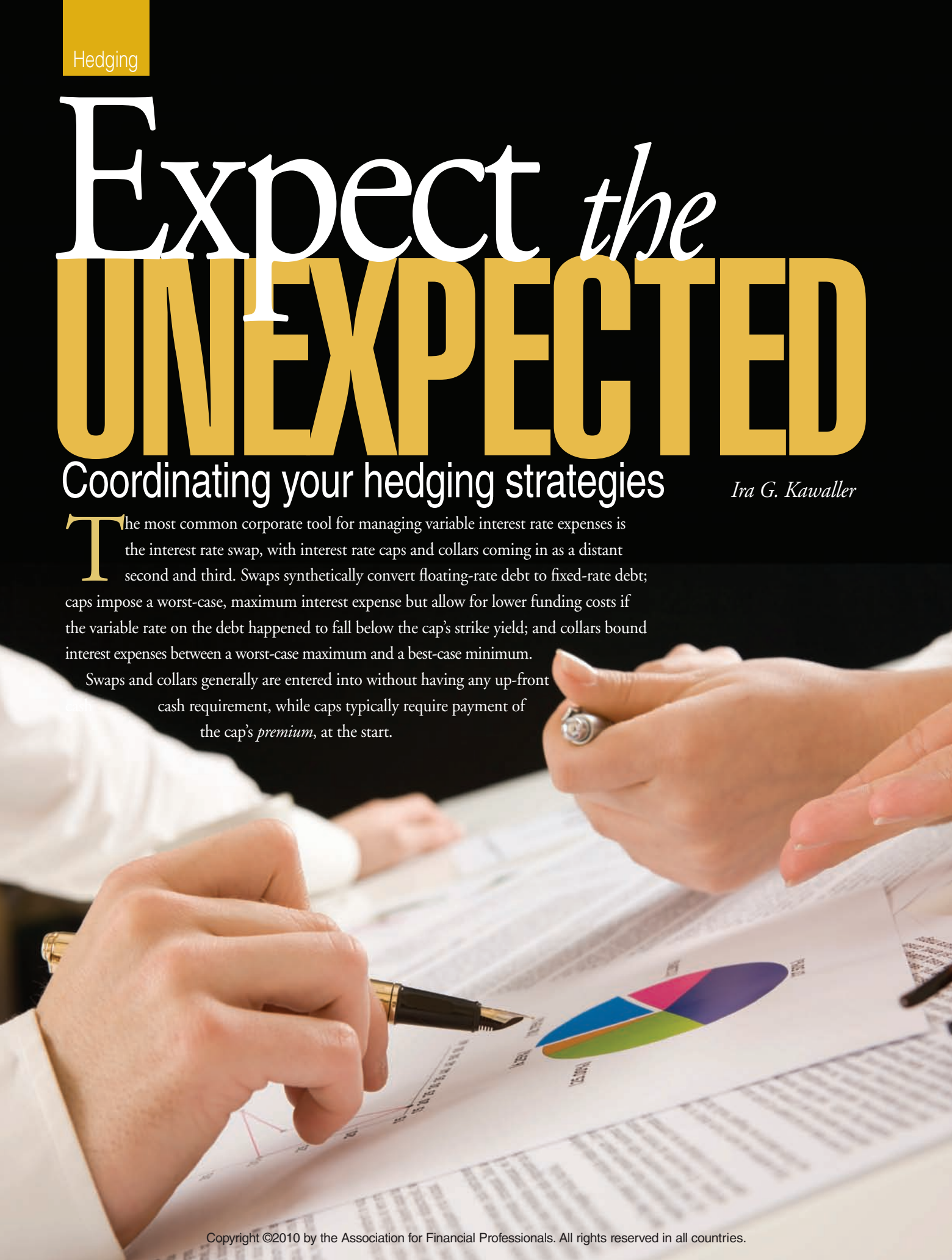
The most common corporate tool for managing variable interest rate expenses is the interest rate swap, with interest rate caps and collars coming in as a distant second and third. Swaps synthetically convert floating-rate debt to fixed-rate debt; caps impose a worst-case, maximum interest expense but allow for lower funding costs if the variable rate on the debt happened to fall below the cap's strike yield; and collars bound interest expenses between a worst-case maximum and a best-case minimum.

Swaps and collars generally are entered into without having any up-front cash requirement, while caps typically require payment of the cap's *premium*, at the start.



Hedging requires coordination between risk managers and financial reporters

Regardless of which tool or objective is selected, these derivatives generally will be tailored to address the interest exposure of some well-defined existing or planned funding mechanism: the notional amount of the derivative would be set to match the projected outstanding balances of the debt, and the hedger would (or should) take pains to assure that the derivative and the debt have matching accrual periods, reset dates, interest rate conventions, and scheduled settlements dates.

Under such conditions, hedges can be expected to perform in textbook fashion, where combined results of the derivative and the variable interest expenses will be precisely predictable—at least economically. For the economics to be translated to the financial statements, however, special hedge accounting is required.

With special hedge accounting, only the effects of the derivative pertaining to the current period would be recorded in current earnings. All other effects, such as unrealized gains or losses relating to future periods, would be recorded in *other comprehensive* income as opposed to affecting *interest expense* in current earnings. Without hedge accounting, the effect of all realized and unrealized gains and losses would be recorded in current earnings, period by period.

Assuming that the derivative is appropriately tailored to the exposure as explained above, the hedge will perform with no ineffectiveness—that is, no earnings effects would arise from the derivative, other than those which serve to meet the stated economic objective. This outcome would be expected to persist throughout the hedge—as long as all goes according to plan.

Unfortunately, for some subset of hedgers, stuff happens. For one reason or another, the original source of the exposure (i.e., existing or planned interest payments) might be modified or eliminated as a consequence of a change in circumstances, prepayments, and/or debt restructuring. In those situations, if the conditions originally detailed in the hedge documentation at the start of the hedge no longer hold, continuing special hedge accounting would require drafting and putting in place new documentation.

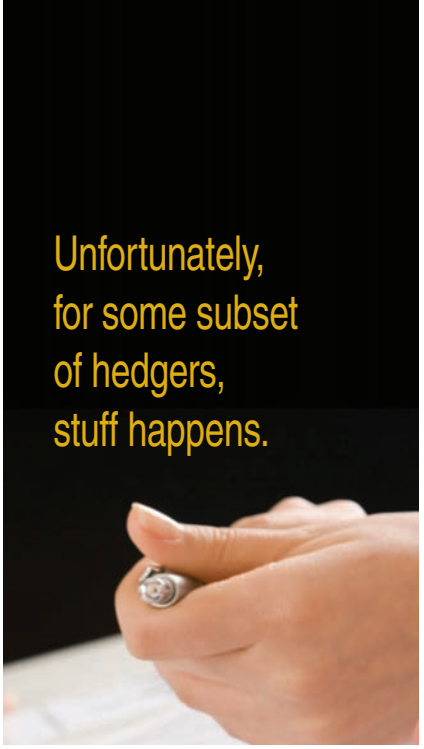
Assuming the planned or existing debt is replaced, but the original derivative no longer perfectly addressed the new risk, the hedger would be faced with two—or possibly three—choices:

1 Maintain the original derivative and re-document the hedge. With this choice, the hedger would have to appreciate that the assumption of perfect effectiveness would no longer apply, therefore some unanticipated (and undesired) earnings consequences would arise under the new hedge relationship. Moreover, new effectiveness testing methodologies might be required.

2 Liquidate the original derivative and replace it with a new derivative structured to match the revised interest rate exposure. Here, perfect hedge accounting would continue without interruption. However, if the original derivative happened to be a liability, the liquidation would require a cash payment by the hedger. This cash requirement could serve as a serious deterrent to this choice.

3 If the original derivative were a swap (Swap 1), the hedger could leave that original swap in place, overlay a new swap as an offset (Swap 2), and then enter into another new swap (Swap 3) or other new derivative to address the revised risk. This approach essentially yields the same economics as the second choice, but it sidesteps the need to come up with the required cash to liquidate Swap 1.

In the third choice, Swap 2 would be a receive-fixed/pay-variable swap. The variable legs of Swaps 1 and Swap 2 should be structured to be equal and opposite, buy the two fixed legs would not be the same, such that the cash flow obligation of Swaps 1 and 2 combined would be determined on the basis of the difference between the two respective fixed rates. Assuming Swap 1 was a liability (which would be the only case where Choice 3 would be considered); the fixed leg of Swap 2 would necessarily be lower than that of Swap 1, such that, over the remaining life of Swaps 1 and 2, the hedger would pay this difference. Thus, in the second choice, the liability value of Swap 1 is paid off at the point of termination, while in the third choice; this liability is paid off over the time. Put another way, the overlay strategy (Choice 3) essentially finances the cost of liquidating Swap 1.



Whether Choice 3 should be preferred over Choice 2, the decision should reflect whether the effective funding cost for liquidating this liability over time is greater or smaller than the opportunity cost associated with affecting the liquidation of the original swap under Choice 2. (Think of the set of fixed payments that result under Choice 3 as constituting principal and interest on a fixed rate, amortizing loan having an original principal equal to the liquidation value of the original derivative, and solve for the effective fixed rate.)

Importantly, substituting one funding source for another will not trigger any acceleration of the reclassification of the existing AOCI—even if the character of the new debt (i.e., the basis for the interest payment calculation) differs from that of the originally defined hedged item. Clearly, FASB wants to preclude any chance of generating discretionary earnings impacts simply by re-engineering prospective financing arrangements or terminating existing derivatives. On the other hand, if the debt is not replaced, that is another story. In this case, early reclassification of the existing AOCI may likely be required—but not necessarily all of it.

Reclassification of the AOCI is mandated only when the originally designate hedged item is now "expected not to occur." This seemingly awkward phrasing is quite intentional, as the FASB makes a distinction between something that may or may not occur, versus something having a high probability of actually not occurring. Thus, the company would have to be pretty confident that the originally designated cash flows designated as the hedged item will not happen (i.e., that debt balances will be below original targets) in order for it to be appropriate to accelerate the reclassification of the associated AOCI.

Depending on the circumstances, the company may face considerable uncertainty about its future borrowing. They just might not know what is coming. This uncertainty would preclude hedge accounting, for any interest payments in excess of those amounts that are probable of occurring, prospectively; but at the same time, the uncertainty would also disallow the acceleration of the reclassification of at least some portion (possibly the majority) of the existing AOCI. Accelerated reclassification would only be appropriate for the portion of interest payments that the company is reasonably sure will not be paid. For instance, if the company knew that their debt balances would fall short of their original targets by, say, $20 million in the next quarter, but that they might possibly ramp up their borrowing after that, the appropriate action would be to accelerate only the portion of AOCI attributable to the $20 million shortfall of debt—but only for the coming quarter. The following quarter, an analogous assessment would be required, etc.

Arguably, the economic aspects of these various unexpected scenarios deserve equal or greater consideration than the accounting concerns. Specifically, what should be done if the company has a derivative in place but where the intended risk has evaporated? The fact is, if that derivative is not hedging anything, it is a speculation. Despite this, many firms in this position may be loathe to terminate the swap (or a portion of the swap representing the overage)—particularly if the swap is in a liability position. Critically, any such liquidation will not have an immediate earnings impact.

Complicating the issue is that maintaining the derivative may seem like a good bet in the current environment. With interest rates as low as they are currently, any prospective rate decline would be quite constrained, while a rate rise could possibly be much larger. Put another way, it may seem quite reasonable to expect that at least some portion of the losses generated to date would have a high probability of being reversed over the remaining life of the derivative, with seemingly little risk of further, substantive losses. Nonetheless, as attractive as that bet might be, it is not a hedge; and companies that hold derivatives in such situations should be expected to represent these positions appropriately to their shareholders.

The take-away from this discussion is that readers should appreciate that hedging strategies require coordination between the risk managers who design and implement risk management strategies and the financial reporters who reflect these activities on company financial statements. While this principal is hardly new, in too many cases, companies that may be sensitive to this concern at the onset of a hedge may lose that perspective as time passes.

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