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Speech by SEC Staff: Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments

by

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Introduction

Good afternoon. As someone that focuses on financial instruments, it's my pleasure to speak with you today about a topic that is near to my heart — Statement 133[1]. Despite the fact that Statement 133 has been in place for over five years, hedge accounting continues to be a significant source of formal and no-name inquiries, is a contributing factor for a significant number of restatements, and it generates a large number of articles in the press. Various aspects of Statement 133 have been discussed at this conference since the issuance of the Standard. Today, I'm going to share some views with you on the application of Statement 133; in particular, a number of issues related to hedge effectiveness that we continue to see.

In order to apply hedge accounting, Statement 133 requires that the hedge relationship is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the risk being hedged, both at the inception of the hedge and on an ongoing basis[2]. To achieve this objective, companies must assess the effectiveness of a hedging relationship both prospectively and retrospectively. The prospective assessment is made both at the inception of a hedging relationship and on an ongoing basis and requires that companies justify their expectation that the relationship will be highly effective over future periods. The retrospective assessment is also performed on an ongoing basis and requires companies to determine whether

the hedging relationship has in fact been effective. If a company concludes that the hedge relationship is effective and all of the other documentation requirements of Statement 133 have been met, hedge accounting may be applied and any ineffectiveness should be measured and recognized in earnings.

During the deliberations of Statement 133, some constituents suggested that the periodic assessments of hedge effectiveness were overly burdensome for certain straightforward relationships, and they asked for relief from the requirements to assess hedge effectiveness. The Board listened to these requests, and they responded by creating several exceptions to the requirement to assess hedge effectiveness and measure ineffectiveness. These exceptions were created for a limited number of narrowly defined circumstances involving straightforward hedge relationships, and included certain criteria that must be met to apply the exception. These exceptions include the shortcut method[3], the critical terms match method[4], and two of the methods of measuring hedge ineffectiveness under DIG Issue G7[5], namely the change in variable cash flows method and hypothetical derivative method.

The Shortcut Method

I'll begin by discussing issues related to the shortcut method. The shortcut method was developed for hedges of interest rate risk involving interest rate swaps and recognized interest-bearing assets or liabilities — essentially debt instruments from either the creditor or investor perspective (the assets) or from the debtors perspective (the liabilities). In addition to the requirements to document the hedge relationship, Statement 133 includes nine additional criteria[6] that must be exactly met to apply the shortcut method[7]. These criteria essentially involve determining whether the terms of the debt and the interest rate swap exactly match, and address terms that were believed to be contained in the typical or straightforward debt instruments that constituents had requested the exception from the hedge effectiveness assessment. The shortcut method essentially acknowledges that if the terms of the debt and the swap do exactly match, any ineffectiveness that does exist would not be significant and can be ignored.

At this conference last year, Mark Northan stated that the staff does not believe that the criteria to apply the shortcut method have a "spirit" or a principle that can be met without complying with all of the stated requirements[8]. That being said, and media reports notwithstanding, the staff does believe that there are relationships that qualify for the shortcut method. However, we continue to see instances where the shortcut method has been applied to relationships that are beyond the intended scope, as well as misapplication of the shortcut criteria, and I'd like to discuss a few examples.

- The first example is trust preferred securities. These securities are effectively debt instruments that are usually issued by certain regulated entities, such as financial institutions or utilities, and they generally contain a feature that permits the issuer to defer making

stated interest payments under certain circumstances. Some companies have entered into interest rate swaps to hedge the exposure to changes in fair value or cash flows from changes in the underlying benchmark interest rate. Some of these swaps contain deferral options like the interest deferral option in the securities while others have not, and we have seen companies apply the shortcut method in both situations.

Companies that have applied the shortcut method when the swap does not contain a deferral option have argued that they do not intend to exercise the option, so they believe the feature does not need to be mirrored in the swap. We believe debt instruments with this deferral feature are ineligible for the shortcut method for a number of reasons. The staff doesn't believe that features that exist within an instrument for substantive reasons (in this case, to comply with regulatory requirements) should be simply assumed away. Additionally, the ability to defer the payment of interest is not typical of the simple debt instruments that were contemplated by the Board when the criteria for the shortcut method were developed, and we believe that such a feature would invalidate the assumption of no ineffectiveness in the hedge relationship[9].

Companies that have attempted to apply the shortcut method when the swap contains a mirror image deferral option have argued that they have met the "spirit" of the shortcut method. However, such a mirror image option in the swap invalidates one of the shortcut criteria, that is, the formula for computing net settlements under the interest rate swap are the same for each net settlement.[10]

- Another example involves cash flow hedges of variable-rate debt that include a call option that permits the debtor to repurchase the debt at the interest reset date at par.

  Companies have argued that since the debt is callable at the interest reset date, the debt instrument is essentially callable at fair value and a call option at fair value has no value, so the debt instrument would not be considered prepayable. However, if the call price for the debt at the reset date is not adjusted for changes in credit sector spreads and changes in the debtors' creditworthiness, the call price would not be fair value, and the debt would in fact be considered prepayable.[11] Companies generally would not want to have a mirror image call option in the swap, because they are hedging forecasted cash flows that are they are asserting are probable of occurring, as opposed to the value of the embedded call option.

In both of these situations, it is quite possible that the hedging relationships will be highly effective with a small amount of ineffectiveness under a full effectiveness assessment, but application of the shortcut method is not appropriate.

Other Methods that Include an Assumption of No Ineffectiveness

Next, I'd like to discuss other methods of assessing hedge effectiveness that include an assumption of no ineffectiveness. In certain hedge relationships, it is possible for a company to match the terms of the hedged item and the hedging instrument so that the known sources of variability that were considered significant by the Board are perfectly matched. This principle is illustrated in the critical terms match method of assessing hedge effectiveness and the two methods of measuring hedge ineffectiveness discussed in DIG Issue G7 that I mentioned earlier.

Under these methods, when all known sources of variability are perfectly matched, there is no need to perform a significant amount of work to evaluate whether the hedge is highly effective or measure the ineffectiveness. While the specific criteria for each of these methods differ slightly, they hold true to this underlying principle that if the terms exactly match, a company can assume there is no ineffectiveness in the hedging relationship. The ongoing assessment of hedge effectiveness consists of verifying and documenting whether the critical terms of the hedged item and the hedging instrument have changed during the period, as well as assessing whether there have been any adverse developments regarding the risk of default by the counterparty to the hedging instrument.[12] If the critical terms exactly match and there has been no decline in counterparty credit risk, a company may assume there is no hedge ineffectiveness. That being said, it is not appropriate to simply assume there is no ineffectiveness in a hedging relationship while ignoring known sources of variability that aren't perfectly matched.

We have seen plenty of situations in which companies have appropriately used these methods. However, we have seen misapplication of these methods to relationships that by their very nature contain known sources of ineffectiveness. The following are several examples of terms that are not specifically mentioned in the critical terms match method or in the two methods of DIG Issue G7 that should be considered nonetheless:

- The critical terms match approach may not be available in a fair value hedge of an interest rate exposure using an interest rate swap. Here, the credit worthiness of the two counterparties might very well differ and these differences would create ineffectiveness.

- The critical terms match approach wouldn't work in a relationship where the settlement date of the forecasted transaction and the hedging instrument differed by several days. Even though the settlement dates differ by only a few days, the differences would create ineffectiveness that should be measured and recognized.

- Similarly, an assumption of no ineffectiveness under the change in variable cash flows method of DIG Issue G7 would not be appropriate for a relationship involving variable-rate debt and an interest rate swap if the interest payment dates on the debt and the swap do not match. The difference in payment dates represents a basis difference that

creates ineffectiveness, and a lack of basis differences is one of the criteria for assuming no ineffectiveness under this method.

In these and other circumstances, the staff believes that a full assessment of hedge effectiveness is appropriate, and companies should measure and record the ineffectiveness that does in fact exist.

In the situations like those I just discussed, questions are often raised when performing the assessment of effectiveness regarding how much work is enough to prove the relationship is highly effective and to measure the ineffectiveness. In the situation where the interest payment date was the only difference between the debt and the swap, it may appear that the difference in fair values and the source of ineffectiveness, which is only derived from the time value of the difference in the cash payments of interest, would be insignificant. However, it isn't appropriate in most situations to rely on intuition alone to prove that the ineffectiveness present in a hedging relationship is immaterial, thus allowing for an assumption of no ineffectiveness. That being said, based on the individual facts and circumstances, the staff has in fact accepted not recording ineffectiveness when there are known sources of ineffectiveness present in the relationship. In these circumstances, the company identified the source of the ineffectiveness, had evaluated the possible impacts under a variety of realistic scenarios that effectively demonstrated that the possible ineffectiveness would be de minimis, and had performed and documented a thorough analysis that demonstrated a continuing and reasonable expectation of effectiveness.

Quantification of Errors in the Assessment of Hedge Effectiveness

When a company has inappropriately applied the shortcut method or assumed there is no ineffectiveness in a relationship, we are frequently asked about the quantification of the error. Some believe that the amount of the error should be measured as the ineffectiveness that would have been recognized had a detailed assessment of hedge effectiveness been completed. Further, some have argued that they have been assessing hedge effectiveness under the critical terms match method or one of the methods in DIG Issue G7, but that they simply did not perform the calculations properly. Generally speaking, if one of these methods was not properly applied, the documentation of the retrospective and prospective assessments of hedge effectiveness under the long haul method and the measurement of hedge ineffectiveness would not have been performed. The documentation of the method of assessing hedge effectiveness, the actual assessments, and the measurement of hedge ineffectiveness are among the general requirements to qualify for hedge accounting. When this documentation is not present, the staff has objected to this approach for quantification of errors for these hedging relationships because it assumes that the error only concerned the measurement of ineffectiveness and that the requirements for hedge accounting were still met. However, if you have a situation where the assessment of hedge effectiveness was not completely met and you believe that the quantification of the error based on the relationship not qualifying for hedge accounting is inappropriate or unfair, we would encourage you to come

speak to us about it.

Summary

I hope that this information has provided some clarity on these methods of assessing hedge effectiveness. Thank you for your attention.

Endnotes

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[1] FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities

[2] Refer to paragraphs 20(b) and 28(b) of Statement 133.

[3] Refer to paragraph 68 of Statement 133.

[4] Refer to paragraph 65 of Statement 133.

[5] Refer to Derivatives Implementation Group Issue No. G7, Cash Flow Hedges: Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied.

[6] Refer to paragraph 68 of Statement 133.

[7] Refer to Derivatives Implementation Group Issue No. E4, Hedging-General: Application of the Shortcut Method

[8] See remarks by Mark Northan at the 2005 AICPA National Conference on SEC and PCAOB Developments

[9] Refer to paragraph 68(e) of Statement 133.

[10] Refer to paragraph 68(c) of Statement 133.

[11] Refer to Derivatives Implementation Group Issue No. E6, Hedging — General: The Shortcut Method and the Provisions That Permit the Debtor or Creditor to Require Prepayment

[12] Refer to Derivatives Implementation Group Issue No. G9, Cash Flow Hedges: Assuming No Ineffectiveness When Critical Terms of the Hedging Instrument and the Hedged Transaction Match in a Cash Flow Hedge.

http://www.sec.gov/news/speech/2006/spch121106tsk.htm

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