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## Hedge Accounting And OTC Derivatives Legislation

*Law360, New York (September 18, 2009)* -- On August 11, the Obama administration proposed new legislation (the "legislation"), which promotes the standardization of most over-the-counter derivatives products ("regulated derivatives").<sup>[1]</sup> The legislation also provides for substantial new regulation for dealers in regulated derivatives and for large end-users<sup>[2]</sup> that hold "substantial net positions" in these instruments.

One of the striking features of the legislation is the endorsement it gives to derivatives strategies that qualify for hedge accounting under generally accepted accounting principles to the exclusion of all other uses of derivatives.

As discussed below, this status is neither warranted by the merits of GAAP hedge accounting nor logically consistent with the legislation's goal of standardizing regulated derivatives.

More significantly, this misplaced focus could potentially subject major end-users of regulated derivatives, such as insurance companies and pension plans, to significant regulation under the

legislation as either a major swap participant or a major securities-based swap participant (hereinafter, collectively referred to as a "major market participant").<sup>[3]</sup>

### **Determination of Major Market Participants**

The legislation directs the Commodity Futures Trading Commission and the U.S. Securities and Exchange Commission to "jointly adopt a rule" within 180 days of the legislation's effective date that more specifically defines terms used therein, including, "major swap participant" and "major securities-based swap participant."

Otherwise, the legislation suggests only two criteria that distinguish end-users that are subject to extensive regulation from those that are not:

1) End-users with “substantial” net positions in regulated derivatives will be subject to extensive regulation as major market participants;<sup>[4]</sup> and

2) Regulated derivatives used to maintain an “effective hedge under generally accepted accounting principles, as the [CFTC and the SEC] may further jointly define by rule or regulation,” will not be included in an organization’s net position for purposes of determining whether its holdings in regulated derivatives is “substantial.”

By heavily regulating end-users with substantial net positions in regulated derivatives while exempting from regulation companies with similar holdings that are used to maintain effective hedges under GAAP accounting, the legislation clearly conveys special status to hedge accounting. However, whether this recognition is warranted is questionable.

Derivatives are widely recognized as effective and valuable portfolio and risk management tools. Many conservative derivatives strategies commonly used by large end-users to more effectively and efficiently invest assets and manage risk do not qualify for hedge accounting.

The economic benefits of derivatives strategies that qualify for hedge accounting are no greater, and the risks are no less, than derivatives strategies that do not. Hedge accounting was adopted to more accurately and completely report an organization’s derivatives holdings, not to mitigate derivatives risks.

There is no question that with the substantial benefits offered by over-the-counter derivatives, there are also substantial associated risks. One of the most significant risks associated with over-the-counter derivatives is the substantial leverage that these instruments provide.

In this respect it can be argued that hedge accounting requirements mitigate this risk, since there is minimal leverage associated with derivatives strategies that qualify for hedge accounting.

However, the same can also be argued for effective economic hedges. Furthermore, neither an effective accounting hedge nor an effective economic hedge mitigates credit, legal, operational and other risks associated with over-the-counter derivatives.

### **Hedging versus Speculation: Misconceptions about Hedge Accounting and the Important Role of Derivatives in Portfolio and Risk Management**

In focusing on hedge accounting, the drafters of the legislation may not have appreciated the many requirements of GAAP hedge accounting or the difficulties associated with maintaining a GAAP hedge; which is why so many end-users either can not, or do not, seek hedge accounting for the derivatives positions they hold.

The legislation's focus on hedge accounting may also reflect commonly held misconceptions about derivatives that result in simplistic characterizations of the use of these products for either hedging or speculative purposes.

Within this framework, derivatives used for hedging purposes are grudgingly accepted; while all other uses of derivatives are condemned as speculative and equated with gambling. This characterization is not only simplistic, it is also inaccurate.

In practice, end-users enter into derivatives transactions to implement a broad variety of risk and portfolio management strategies that do not fall neatly within a binary framework.

Organizations commonly use total return swaps to quickly gain diversified exposures to emerging markets where liquidity constraints, transaction costs and local legal and regulatory restrictions, make it economically unfeasible to do so in the cash market.

Similarly, organizations that need to acquire a fixed income asset, with specific terms and associated economic characteristics (e.g., term, coupon, par value) to meet specific portfolio or risk management needs of the company, may not find that asset in the cash market.

The cash asset either may not be available or not available at an appropriate price. Under these circumstances, portfolio managers frequently use a credit default swap or other derivative instrument in combination with a cash instrument, to create a "synthetic" asset that replicates the required economic characteristics.

Fixed income portfolio managers also use interest rate swaps, caps, floors and swaptions in a portfolio overlay strategy to express an opinion on the direction of interest rates: extending the duration of the portfolio when rates are high and expected to fall, and lowering duration when rates are low and expected to rise.

Also, additional income can be generated by an organization in a flat or falling market by selling call options on assets held in the organization's portfolio.

Some of these derivatives strategies have hedging benefits but most are generally not considered hedges per se. However, when used prudently with proper oversight, these strategies are no more speculative than the same investment in the cash market would be.

If it is permissible and prudent for a company to take a position in the cash market, why should it be considered a speculative bet to use regulated derivatives to more cost efficiently take the same economic position?

## **GAAP Hedge Accounting**

The rules for determining whether a derivatives position maintained by an organization is an “effective hedge” under GAAP are set forth under the Financial Accounting Standards Board Statement No. 133, Accounting for Derivatives Instruments and Hedging Activities (“FASB 133”).

FASB 133, issued in June 1998, requires an organization to record each outstanding derivatives transaction on its balance sheet and to report all changes in value of the instruments through its income statement. However, the change in value of derivatives positions that qualify for hedge accounting have no impact on earnings under FASB 133.[5]

Under FASB 133, only derivatives used to maintain an effective hedge against (1) changes in the fair market value of assets, liabilities or firm commitments of an organization; (2) risks associated with changes in cash flows from individual assets or a portfolio of assets as a result of changes in interest rates or fair market values; or (3) foreign currency exposures from net investments in foreign operations can qualify for hedge accounting.

Hedges of subcomponents of these risks, for example, changes in the fair market value of a bond caused by shifts in the yield curve,[6] may not qualify for hedge accounting.

In order to qualify for hedge accounting, changes in the value or cash flow of a derivatives hedging position must also be “highly effective” in offsetting changes in the value or cash flow of the hedged item. FASB 133 also requires companies to formally document the hedge at inception.

Generally, this documentation must identify the hedged item and the associated derivatives position, the nature of the risk being hedged, the objective and strategy for mitigating the risk, and how the effectiveness of a hedge will be measured over its projected life. The effectiveness of the hedge must also be tested and reported for each financial report of the organization and at least every three months.[7]

To maintain a highly effective hedge, the critical economic terms of the derivatives instrument, such as notional amount, term, and rate, must closely match the corresponding terms of the hedged item.

Ironically, by promoting the standardization of regulated derivative contracts, the legislation will make it more difficult for end-users to identify derivatives contracts with terms that closely match the terms of the asset or liability they seek to hedge.

In this regard, the Legislation is at cross-purposes with itself. Regulated derivatives contracts may be standardized, but not the risks that organizations seek to hedge.

Finally, assets, liabilities and firm commitments may be aggregated and hedged on a portfolio basis under FASB 133. However, hedges of the fair market value of portfolios rarely qualify for hedge accounting.

In order for these hedges to qualify for hedge accounting, each individual hedged item in the portfolio must share the same risk profile. As a practical matter, this is rarely achieved.[8]

### **GAAP Hedge vs. Economic Hedge**

Many hedging strategies do not qualify for hedge accounting under GAAP. These derivatives strategies nonetheless act as effective economic hedges, reducing or eliminating an organization's exposure to specific risks and lowering its earnings volatility.

Organizations frequently use regulated derivatives to hedge against basis and liquidity risks and against fair market value risks associated with changes in the yield curve even though these hedges generally do not qualify for hedge accounting.

Balance sheet hedges, which hedge an organization's foreign currency exposure under liabilities, which are not backed by assets in the same currency, also do not qualify for hedge accounting.

Similarly, even though, as noted above, portfolio hedges rarely qualify for hedge accounting, these hedges are far more cost efficient and effective than individual hedging each asset or liability in the portfolio. The economic benefits of portfolio hedging vastly outweigh the accounting benefits a company can achieve with individual hedges.

Credit default risk can be separately identified and hedged under FASB 133. Although credit default swaps are effective economic hedges of credit risk,[9] as a practical matter, they can not qualify as effective hedges under GAAP: the day to day changes in the market value of the credit default swap do not effectively off-set corresponding changes in the market value of the hedged bond.

Asset liability matching, or ALM, is an important risk management process for insurance companies and pension plans. The goal of ALM is to fine tune the duration and convexity of a portfolio of assets (liabilities) to more closely match the duration and convexity of the portfolio of liabilities that they back.

The duration and convexity of liabilities can also be adjusted to more closely match the corresponding assets. Although these adjustments can be effected through purchases or sales in the cash market, duration and convexity can be more accurately and more cost efficiently adjusted using derivatives overlay strategies.

Unfortunately, however, derivatives held to effect these strategies do not qualify for hedge accounting.

Equity index options; total return equity index swaps; interest rate swaps, caps and calls; and swaptions and other derivative products commonly used by insurance

companies that sell various annuity products to hedge their exposures under these products to increases or decreases in equity market values and interest rates, also do not qualify for hedge accounting.

## **Conclusion**

Derivatives clearly have significant potential risks and the over-the-counter derivatives market needs to be carefully regulated to better insure these risks are adequately mitigated. Unfortunately, the distinction accorded derivatives positions used to maintain effective hedges under GAAP is not warranted.

Rather than promoting better risk management practices, or the more prudent use of derivatives, this false distinction promotes the common misconception that derivatives are used for only two purposes: hedging and speculation.

Over-the-counter derivatives can also be invaluable tools which enable organizations to more efficiently and effectively invest assets and manage risk. Due and careful consideration of both the benefits and the risks of over-the-counter derivatives should be reflected in the regulation of these products.

Regulation of the over-the-counter derivatives market, which if ultimately adopted by Congress and implemented by the CFTC and the SEC, should also provide a better and more nuanced framework to distinguish between the prudent use of over-the-counter derivatives products and truly “speculative” use of these instruments.

If the legislation is ultimately adopted by Congress, with its emphasis on hedge accounting, end-users with risky derivatives strategies may go unregulated while insurance companies, pension plans and other prudent end-users of derivatives could be unnecessarily subjected to greater regulation.

The legislation may also expose end-users to greater cost and risk if it is no longer feasible or possible for them to implement portfolio and risk management derivative strategies.

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[1] As currently proposed, cross-currency swap transactions and foreign currency forward transactions are not regulated by the legislation. However, in a letter to Sen. Tom Harkin, Chairman of the Committee on Agriculture, Nutrition and Forestry, Gary

Gensler, Chairman of the Commodity Futures Trading Commission, proposed that foreign currency derivative products be covered by the legislation.

[2] “End-users” enter into derivatives transactions for specific portfolio or risk management objectives. In contrast, as financial intermediaries, “dealers” profit from making a market in derivative instruments, buying and selling at bid/ask spreads. Dealers are identified in the legislation as “swap dealers,” and defined as any person who as part of a regular business engages, “in the business of buying and selling swaps for such person’s own account, through a broker or otherwise.”

[3] The legislation categorizes regulated derivatives as either swaps, which the Commodity Futures Trading Commission is primarily charged with regulating; or security-based swaps, for which the Securities and Exchange Commission is the responsible regulator. Under this framework, end-users with substantial net positions in swaps are “major swap participants” and end-users with substantial net positions in securities-based swaps are “major securities-based swap participants.”

[4] “Substantial” is not defined in the legislation.

[5] Organizations are allowed to make off-setting entries in their P&L to eliminate this impact.

[6] If the yield curve steepens, the spread between bonds of differing maturities grows wider. When the yield curve is flatter, this spread narrows. The market value of a bond is partially impacted by these changes in yield spreads.

[7] Hedges that qualify for the so-called short-cut method are exempted from these testing requirements. Unfortunately the requirements of the short-cut method are so difficult to meet, the significant terms of the derivatives position must perfectly match the corresponding terms of the asset or liability it hedges, this method is rarely used.

[8] It is slightly easier to qualify cash flow hedges on a portfolio basis for hedge accounting.

[9] If an bondholder has hedged its credit exposure to the issuer with a credit default swap when the issuer defaults, the bondholder will be entitled to reimbursement for its losses on the bond by its credit default swap counterparty (the floating rate payer).