

reader's CORNER

Dear Mr. Mennis:

My bank regularly utilizes plain vanilla interest rate caps, floors, and swaps to manage its overall interest rate risk position. Can you provide me with a "layman's" summary of the key elements and implications of FAS 133, *Accounting for Derivatives Instruments and Hedging Activities*, that I could share with my Board of Directors?

Here's an answer to your question, prepared by Matt Pieniazek, Principal of Darling Consulting Group, Newburyport, MA.

The first thing for your board to understand is that the new accounting requirements, which become effective for fiscal years beginning after June 15, 1999, do not change the fundamental economics of the bank's current risk management activities. What will change is how your financial statements will reflect the use of derivatives. With few exceptions, the new rules will require that you carry all derivatives on the balance sheet at fair value. How changes in the fair value of your derivatives affect earnings and capital will depend on three factors:

- Whether the derivative is part of a bona fide hedge
- The type of hedge utilized (e.g., fair value, cash flow, or foreign exchange)
- The derivative's effectiveness in hedging the identified risk(s)

Bank hedging activities under the new rules typically will produce some measure of earnings volatility. The extent of that volatility depends on the type of hedges used, with cash flow hedges expected to produce greater volatility than effectively structured fair value hedges. (I won't discuss foreign exchange hedges, because community banks rarely use them.)

Fair value hedges. You would use a fair value hedge to "undo" the fixed-rate terms of an asset or liability. In doing so, you are either protecting the price/value of an asset or liability or converting a fixed-rate asset or liability to a variable rate.

Example: You might use interest rate swaps to convert synthetically a fixed-rate loan or certificate of deposit to a variable-rate instrument.

With a fair value hedge, both the derivative and the hedged item are carried on the balance sheet at fair value. The accounting rules ensure that any ineffectiveness associated with hedges will affect current earnings, while the positive impact of an effective hedge will be deferred, as an adjustment to the basis of the hedged item, recognized as a yield adjustment and/or upon its sale.

Cash flow hedges. For most community banks, cash flow hedges will be designed to protect variable-rate assets and liabilities from the risk of changes (up or down) in interest rates. By using interest rate caps (e.g., for borrowings), floors (e.g., for loans), or swaps, your bank reduces the uncertainty associated with future interest income and/or expense cash flows. The accounting rules will require that you reflect the ineffective component of hedges immediately in current income while deferring the impact of effective hedges as adjustments to capital, recognized subsequently in earnings as the hedged cash flows occur.

It is important to note that cash flow hedges frequently include the use of options, such as caps and floors. Changes in the price of these instruments may reflect the impact of time value and volatility rather than any change in their intrinsic value. Because changes in time/volatility value are unlikely to contribute to a hedge's effectiveness, related price changes will be recorded in current income, which can produce "measurable" earnings volatility.

An important point for your board is the extent to which favorable hedge accounting treatment under FAS 133 depends on the bank's very specific delineation of risk management policies, objectives, and strategies. Management will have to allocate additional time and resources to document, monitor, account for, and report the results of derivatives hedging activities.

A number of implementation issues remain unanswered. Particularly significant for banks are the questions surrounding the hedging of "similar items" (e.g., pools of loans or deposits). Interpretations continue to be inconsistent, which is unfortunate, because the potential impact ranges from nightmarish to inconvenient, depending on where the dust settles.

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