

WHY BANKS SHOULD OPTIMIZE HEDGE ACCOUNTING STRATEGIES

Q&A with Juergen Ferber, Treasury and Risk Vertical Lead - Financial Institutions, EMEA at FIS

Why are CFOs and CROs focusing (again) on hedge accounting?

The highest interest rates of this century have led to large revaluation effects via P&L (profit and loss) statements and OCI (other comprehensive income), reducing the regulatory capital of banks. This volatility arising from valuation effects was largely driven by swap hedges not in a hedge accounting relationship or FVOCI (fair value through other comprehensive income) portfolios that were not hedge accounted for. Besides, large interest rate spikes resulted in ineffective hedges (results breached the 80% - 125% bright line), creating one-off P&L impacts, which are difficult for management to anticipate and quantify, especially when using proxy hedges. Furthermore, smaller non-hedge accounted positions, which were not hedge accounted for across large banking groups and created small results in stable low-interest rate environments, have suddenly created significant results to banking groups. Lastly, consumer behavior has changed the asset composition on the balance sheet and deposit outflows reduced hedge capacity, provided the EU carve out was applied.

The changed economic environment, rate rises and consumer behavior reshaping banks' balance sheets required a disciplined review of hedges and hedging strategies.

What should banks do now to ensure their balance sheet is futureproof?

Banks are advised to review their underlying interest rate risk created by their core business products, as well as their liquidity and funding positions and economic hedges. It is important to analyze and understand the differences between economic hedging and accounting hedging perspectives. Though treasury activities are fiduciary in nature and may seem risk flat from an economic point of view, accounting mismatches can create significant volatility in the P&L or OCI of the financial institution.

Additionally, it is crucial to assess risks both from a standalone legal entity and a consolidated group level perspective to minimize volatility. It is worthwhile to investigate if you have hedge capacities elsewhere in the group to reduce accounting PV01 exposure.

Finally, stress testing and risk management play a key role to ensure preparedness for the future. Running stress tests and "what-if" scenarios on current and future portfolios in the economic value of equity (EVE) and accounting view will provide more confidence in the bank's strategic hedging. Stress tests can help formulate risk appetite and calibrate risk limits, as well as define a management action plan for various realistic stress scenarios, i.e., rates up and down, as well as rate steepeners and rate twists.

How can FIS help?

Large interest rate increases have proven that spreadsheets are not fit for purpose in managing banks' balance sheets. Challenges include the explanation of large P&L movements and splitting these into drivers (amortization, interest rate, XCCY basis, FX, etc.), as well as running appropriate effectiveness tests at scale. FIS® can help!



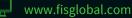
Our solution ensures comprehensive coverage of various types of hedge accounting:

- Fair value hedge accounting
 - Micro
 - Macro/portfolio (algorithm-based portfolio selection and optimization)
 - IFRS 9 DRM (to become effective in the future)
- Cash flow hedge accounting
- Net investment hedge (including forward points and XCCY Basis)

Our solution ensures full transparency and reporting for ALCO and board dashboards containing PV01 and P&L reports, including an extensive P&L explanation, (i.e., pull-to-par effects, interest rate-related effects, hedge ineffectiveness impact, etc.). The dashboards can also display stressed P&L results as well as the difference between economic risk and accounting risk all in one system. No reconciliation between different systems is required.

One of the core strengths of our software is the simulation and stress-testing engine, which produces results on a full revaluation basis. It enables the user to run what-if scenarios, i.e., before onboarding new trades or offloading current trades (pre-deal hedge accounting testing). Once the system is live, the performance of stress tests as part of your enterprise risk management can be done on the fly. This can be used for firm-wide, risk appetite, European Banking Authority (EBA), Bank of England (BOE) and other internal and external (multiyear) stress tests and can be flexibly configured to fill templates from regulators. Finally, hedge accounting is "just" one element of a much larger integrated balance sheet management solution. Other modules include ALM, Liquidity (LCR/NSFR), IFRS 9 Impairment, FTP, Market Risk and Capital.

Take your balance sheet management process to the next level. Talk to us today!



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