

Hedging with Derivatives, Part 2

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Editor's note: In "Hedging with Derivatives, Part 1—How do derivatives hedging programs benefit credit unions?" (InsideRISK, Vol. 3, No. 1, Winter 2003), Graham discussed how an interest-rate swap (IRS) could be used to hedge interest-rate risk in the balance sheet and how one measures whether this type of derivative performs as expected during its lifetime. In Part 2, Graham addresses the various board, regulatory and legal steps that a credit union will need to take prior to executing a hedge. Graham also addresses the accounting issues involved at a high level.

The distinct nature of WesCorp's derivatives hedging program

A little more than a year ago, the NCUA approved a pilot program enabling WesCorp to provide "fast track" access to the financial derivatives market for our federally chartered members. To the best of my knowledge, this is the only NCUA-approved program that readily offers a single source for education, consulting, structuring, execution, and ongoing monitoring and evaluation for derivative hedge transactions.

WesCorp's "fast track" hedging program is particularly significant because credit unions had hitherto been largely precluded from entering the derivatives market because of significant regulatory hurdles. The checks and balances negotiated between WesCorp and the NCUA represent "best practices" and afford credit unions the comfort of knowing that any derivative executed will be appropriate and well structured, and most important, reduce the level of interest-rate risk on their balance sheet. In particular, WesCorp conducts an in-depth analysis of the credit union's risk position to ensure that any derivative solution selected is in fact the best method available to reduce risk. Alternatives might include raising term deposits, fixed-rate borrowing, portfolio restructuring, asset sales, or loan participations.

On the following pages we will discuss the requirements negotiated between WesCorp and the NCUA for participation in our program in order to get a better understanding of how derivative hedging works. We will discuss in detail the legal and financial requirements, board responsibilities, education, infrastructure, policies and procedures, and accounting requirements needed to ensure the successful implementation of a derivative hedging program.

How does my credit union qualify?

A federally chartered credit union first applies to their local regional NCUA office for permission to participate in WesCorp's program. The approval is normally obtained in less than seven business days. For those credit unions that participate in our program, WesCorp enters into long-term legally binding contracts with them to ensure that all the minimum requirements are satisfied. The contracts are standardized throughout the financial services industry and are referred to below as International Swap Dealers Association (ISDA) contracts.

Initially, there is a master agreement that defines all terms used in future transactions and a credit annex that defines the methods of mitigating default risk by either party. Subsequently, the actual transactions are consummated with a much simpler confirmation. Once a credit union completes the standardized program requirements, no further permission is required from NCUA.

The requirements include:

1. The financial capacity to support a transaction.
 - At least seven percent statutory net worth
 - Positive earnings for the last twelve months

- The ability to meet the bilateral collateral requirements if their financial performance deteriorates
 - The capacity to operate within the maximum IRR limitations
2. The legal qualification and contractual requirements.
- An ISDA master agreement (including the credit annex containing a bilateral collateral agreement)
 - Board resolutions
 - Officer certificate (listing transaction authority)
 - Legal counsel's opinion (that swaps are an allowable transaction under regulation and bylaws)
3. Accounting qualification and requirements.
- Independent audit
 - Establishment of appropriate accounting policies and procedures
 - Accounting opinion that policies and strategies are compliant with FASB 133
 - Analysis of proposed hedges on the balance sheet with parallel interest-rate shocks and quarterly hedge evaluations during the life of the executed transaction
 - Independent monthly fair market valuations of all outstanding derivative transactions.

Failure to perform the last two items is a default and may cause the liquidation of the outstanding transactions.

4. Minimum interest-rate risk policy requirements.
- Board-approved interest-rate risk policies (After an immediate three percent parallel interest-rate shock, the policies require a minimum five percent NEV ratio, a maximum of 50 percent volatility in NEV and positive-projected 12-months NII.)
 - The aggregate notional principal amount of derivatives will not exceed a maximum 250 percent of capital
 - Specific board policies on correlation targets and internal controls must be established to separate execution and reporting
 - Performance monitoring by the asset/liability committee and the board
5. Transaction execution—Any contemplated transaction is:
- Used solely to reduce the absolute level of IRR
 - Correlated with a specific balance sheet item to provide an effective hedge
 - Board approval for each transaction (or delegated authority to staff with specific limitations)
6. Education—At the very least, the board and senior management should participate in a WesCorp presentation on derivatives, and they should have a good understanding of the fundamentals.

While the program requirements are extensive, they are designed to ensure that your credit union will be well-prepared to make conservative, appropriate and risk-reducing decisions that fit your balance sheet, before the credit union enters into this fast track program. We are confident that when these requirements are met, your credit union will have the ability to select the appropriate IRR reducing method, and if the choice is derivatives, apply them safely and soundly.

Why extensive legal documentation?

First of all, I would like to point out that WesCorp supplies drafts of all the required documents. Your counsel's work is to review rather than produce the initial drafting. WesCorp is responsible for ensuring that all the derivative transactions that take place under the "fast track" delegated authority are appropriate and have clarity. These legal documents have been tailored and honed for more than 20 years by derivatives market professionals and have become standardized to such an extent that virtually all frequent users of derivatives accept them.

The ISDA Master Agreement defines numerous derivative conventions that are necessary to ensure a liquid market. These conventions define such items as payment dates, accruals, day counts, definitions of indices, netting procedures, termination events, confirmations, and transfer rights. If either counterparty to the interest-rate swap experiences unexpected credit deterioration, the credit support annex, attached to the ISDA Master Agreement, outlines what amount and what type of collateral should be lodged with the other party. This ensures that financial obligations under the derivative transaction are met. Both parties sign these two documents.

Your board needs to execute resolutions that list:

- The proposed transaction types and copies of approved policies that implement the analyses and reporting requirements.
- The aggregate limits for aggregate notional principal amounts permitted for each type of transaction. The latter amounts must be appropriate for the size, capital and earnings outlook for your credit union. WesCorp needs to have copies of these resolutions.

WesCorp also requires an officer certificate for persons authorized to execute transactions along with a written opinion from the participating credit union's legal counsel that the proposed transactions are legal.

Amending the asset/liability management policy

NCUA recognizes that the safe and effective use of financial derivative instruments requires appropriate controls and monitoring systems. It has established minimum requirements for interest-rate risk policies and asset/liability modeling capabilities for federally chartered credit unions participating in the program. Requirements for state-chartered credit unions may be different in each individual state.

The minimum asset/liability modeling requirements include prepayment models, non-maturity deposit account modeling and particular assumptions, yield curves and cash flow valuation, interest-rate shocks and an off-balance sheet derivative capability, and an option valuation module.

While your existing ALCO committee probably addresses membership, general risk management, capital, cash and liquidity management, portfolio management, and compliance with credit union regulations, it more than likely does not cover the subject of financial derivatives. WesCorp can provide you with a copy of an asset/liability management policy that includes financial derivatives. The policy covers definitions, approved instruments, objectives, authority and responsibility, transaction limits, reporting requirements, credit risk, liquidity risk, legal risk issues, and accounting issues.

FAS 133 and derivatives (hedging) accounting policy

FASB has introduced an accounting policy for derivative transactions—FAS 133. The policy places emphasis on proving that a derivative transaction qualifies for hedge (accrual) accounting. This thousand-page document, including later amendments, can be extremely daunting. Reading it can certainly put you to sleep more effectively than counting sheep. However, in reality, the bulk of the issues for credit unions planning a simple liability extension are covered in about five pages.

Unfortunately, the key sections are spread throughout the book so you will need some guidance in honing in on the relevant issues.

Posting the interest accrual debits and credits is a relatively straightforward issue. It is meeting the documentation requirements that can be tricky and requires some preparation and planning. A number of credit unions have already entered into derivative hedge transactions, and they have been able to put in place adequate paperwork that ensures minimal volatility in future P&L statements resulting from mark-to-market changes on their derivatives.

FAS 133 requires that all derivative instruments are subject to market value accounting. The hedged balance sheet item is also subjected to market value accounting where the derivative transaction qualifies as an acceptable hedge, hopefully offsetting any impact on the profit and loss statement. Regular testing of hedge effectiveness is also required and, should the hedge prove ineffective—typically where the 80 percent correlation with the hedged item is less than 80 percent—the change in market value in the derivative transaction must be recognized in current income.

WesCorp will work with you to also ensure that the cash flows on that derivative floating rate leg mimic, as closely as possible, the cash flows of the balance sheet liability in both timing and the rate setting of the liability interest payments. There is also some room to react to the pricing of local competitors and liquidity requirements without triggering the need to record the derivative mark-to-market valuation and potential changes in the profit and loss statement. This is done by splitting the pricing decision into two pieces, one that follows the benchmark used in the derivative hedge, and a second piece that reflects changing competitive issues. There are limits on the relative size of the marketing spread that you will need to discuss with your auditors.

To ensure that hedge accounting treatment is available, a number of steps need be taken. From the beginning, documentation needs to define what transactions are being hedged, what instruments are being used and for what purpose, and how the correlation of the two will be measured. Hedge accounting is only allowed for specified assets or liabilities. “Macro” hedges (i.e., where you look at the entire risk of the balance sheet) are not allowed under FASB 133. In addition, once the hedge documentation is put in place, it cannot be changed. Therefore, it is important that these statements are thought out in advance. The hedge effectiveness needs to be measured, according to the pre-designed methodology, both at the outset and at least every three months.

For example, ALCO committee minutes would record the interest rate each time the floating leg of the derivative is re-priced, and how the ALCO committee re-priced their credit union’s liabilities based on that rate as the principal parameter. On the basis that this achieves 100 percent effectiveness, the monthly mark-to-market of the derivative would appear in Other Comprehensive Income (OCI), and the other entry would appear as a receivable or a payable. The net cash flow of the derivative each period and the matching interest payment on the liabilities would be recorded through the profit and loss statement in the same reporting period. Clearly, the key to hedge accounting treatment under this standard is ensuring that a hedge meets the effectiveness test.

Another required document is a new derivatives (hedging) accounting policy. WesCorp will be happy to supply you with a copy of a draft policy that you can use as a model for developing your own internal policies. The main features of this draft include:

- A policy overview
- Definitions per FAS 133
- Implementation considerations
- A description of the derivative/hedge to be used—fair value or cash flow
- Generalized accounting considerations
- A couple of short appendices (May be used as a record for each derivative creating synthetic fixed-rate certificates and as an indication of forecasted certificate issuance and how they will be hedged in a fixed interest rate through the use of matching derivatives.)

Post derivative execution—ongoing reporting requirements

While we have already noted many of the reporting requirements, let's recap what the credit union will need.

1. A monthly fair market values report. WesCorp will obtain independent valuations for our credit union counterparties.
2. The following reports should be provided on a quarterly basis to WesCorp, your credit union board and your regulator:
 - The mark-to-market impact on the hedge program of a ± 300 bps rate shock
 - The mark-to-market impact of a 300bps rate shock after the derivative matures
 - For liability hedges, estimate the mark-to-market for the funded asset (typically a liability extension is designed to offset the IRR in long-term assets, such as mortgage loans, that is already on the balance sheet or is planned in the future)
 - Evaluate the hedge performance against original board objectives.

As in traditional accounting where we measure variance analysis of actual versus forecast costs and revenues, the requirements associated with regularly measuring the effectiveness of the derivatives seem more than reasonable.

What if my credit union is state chartered?

The recommendations and requirements that have been outlined to this point reflect the agreement between NCUA and WesCorp related to federally chartered credit unions. However, as previously stated, we believe that these requirements reflect “best practices.” In fact, they are less onerous than the internal requirements that we impose on our own derivative activities. We believe that they are appropriate for most credit unions and are designed to ensure that:

- The hedging process is appropriate, risk reducing and fully understood by the board, senior management and the ALCO committee,
- The derivatives' effectiveness is monitored regularly throughout its life,
- All the legal documents are in place, and
- Accounting processes are properly managed.

Now, it would seem reasonable to believe that this “gold standard” would be acceptable to many state regulators, and that is precisely what we are finding as the program grows nationally. WesCorp is in the ongoing educational process of working with NASCUS and DFIs throughout the nation. We invite you to talk with us about your state, and we will be pleased to present our program to its regulators.

How long does this process take?

It would be foolish of me to write that the process is fast. By the time you reach this part of the presentation, you have read nearly all the requirements associated with NCUA's delegated “fast track” derivative program at WesCorp. The process is thorough, fairly mechanical, and of course, WesCorp will supply your credit union with standard drafts for each required document.

Considering the three basic ways of reducing interest-rate risk in a credit union's balance sheet—fixed-rate borrowing, loan participations and derivatives—all three require board resolutions, the opinion of your legal counsel, and documents. It is our experience, however, that it will take approximately two months to complete the education, the measurement of the adequacy of the asset/liability risk management system, and the legal and accounting processes. The actual amount of time, beyond two months, is up to you, your management and your board of directors.

Conclusion

There is no “right amount” of IRR or “best way” to reduce IRR that works for all credit unions. A credit union’s expertise, membership, product mix, capital ratio, loan demand, liquidity ratio, and credit concentrations will all determine which IRR method is best suited to your credit union. The best method may be one of these or a combination.

Let WesCorp share an outline of all three programs with you. Take a good look at your credit union’s current financial position and together we can reach the best way to reduce IRR at your credit union.

I hope our discussion has answered many of the questions you have on reducing IRR in your credit union’s balance sheet through the use of derivatives. If you need more assistance, please contact John Lau at (800) 442-4366, extension 6302, or by e-mail at jlau@wescorp.org.

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