Introduction

In July 2014 the International Accounting Standard Board (IASB) published International Financial Reporting Standard (IFRS) 9 Financial Instruments, thereby finalizing hedge accounting rules for micro fair value hedging. Rules related to portfolio fair value hedge are still under consideration. While the declared objective of IFRS 9 is to move hedge accounting processes closer to the realities of risk management, the requirements still represent an operational challenge that would benefit from both automation and standardization.

The objective of hedge accounting, as defined by the IASB, is to represent the effect of an entity’s risk management activities in its financial statements, when financial instruments are used to manage exposures to particular risks – and those risks could affect profit or loss. Without the application of fair value hedge accounting, classical hedging activities will cause swings in the income statement. This is because derivative instruments must be classified at fair value though profit and loss, while hedged items are accounted for at either amortized cost or fair value through other comprehensive income (FVOCI). As a result, the income statement will only contain the change in fair value caused by variations in the hedged risk of the hedging instrument – while the hedged item is still accounted for at amortized cost or FVOCI. Given the importance now attributed to income statements, any solution that helps reduce volatility will add untold value.

Ambit Focus helps you to achieve hedge accounting compliance under both IAS 39 and IFRS 9. The solution offers full coverage of hedge accounting requirements for micro and portfolio fair value hedging. These functionalities are embedded within a full asset liability management (ALM) platform, supporting centralized decision-making and delivering consistent results.

The IASB’s requirements are integrated throughout all Ambit Focus modules. All assets, liabilities and derivatives are classified according to accounting categories to allow for a correct carry amount calculation. This encompasses full mark-to-market valuation as well as amortized cost calculation using the effective yield method.

Accounting principles also affect the computation of future earnings and capital within dynamic earning simulation. This has an impact on the following calculations:

- Accrued interest income
- Fair value changes
- Amortized cost changes based on the effective yield method
Supporting The Hedge Accounting Process within Ambit Focus

Ambit Focus provides support for the entire hedge management process as depicted below.

Figure 1: Life cycle of hedge relationships

- Definition of Hedge Relationship
- Prospective Effectiveness Test
- Retrospective Effectiveness Test
- General Ledger Entries
- Closing and Amortization of Hedge Adjustments
Identify hedge members

In Ambit Focus the definition of a hedge relationship is based on the same data used in the other modules of the application, thus providing consistent results across different functional areas. This effectively makes use of existing ALM and liquidity risk implementations – considerably reducing the extra effort involved in putting a hedge accounting process in place.

For micro fair value hedging, the solution helps the user to find the best matches. Several search criteria such as end date, coupon and duration range are available to help you find the corresponding hedged item or hedging instrument efficiently. Alternatively, pre-defined relationships can also be imported into the system. Additionally, the application supports late designation out of the box.

In contrast to micro fair value hedging, portfolio fair value hedging involves entire portfolios with many members. The composition of hedged items changes constantly over time (e.g. due to prepayments, new volume, etc.) and the portfolio of hedging instruments is actively managed as well. To perform hedge accounting in an efficient manner on such large and constantly changing volumes, automation is a must. For these reasons, the portfolio fair value hedging process within Ambit Focus is entirely automated.

Furthermore, the relationship between hedged items and hedging instruments is not as clear cut as it is for micro fair value hedging. So, generating portfolio fair value hedges requires a sophisticated allocation algorithm that ensures an optimal match between the risk profiles of the hedging instruments and hedged items – i.e. creating effective hedge relationships and maximizing the usage of available hedging instruments.

To achieve these objectives, zero bonds are generated with exactly the same risk profile as the underlying portfolios of real items, as measured by basis point value sensitivities. This allows for the proper mapping of instruments on a user-defined grid-point structure and fastens up calculations. The algorithm matches hedged items with hedging instruments, based on a user-defined sequence. This will allow for the shared use of swaps across several portfolios. A proportion of a swap can for example be used to hedge down an exposure in a FVOCI portfolio and the remainder to hedge exposures in the amortized cost portfolio. Consequently, a user-defined number of hedge relationships will ensure that swaps are used in an optimal manner.

Prospective effectiveness test

For a newly created hedge relationship to qualify for hedge accounting, the prospective effectiveness of the relationship must be assessed. Three different test methods are offered by Ambit Focus to assess hedge effectiveness:

- Ratio analysis (dollar offset)
- Regression analysis
- Risk reduction

Within the application itself, users can define the limits of what they deem an effective hedge relationship. This allows for defining criteria that are in line with internal risk management policies.

Prospective effectiveness tests require both the hedged item and the hedging instrument to be projected into the future. Within Ambit Focus this is achieved through the advanced simulation capabilities of the solution’s calculation engine. Hedge effectiveness can be assessed under any kind of user-defined rate curve shock.

Figure 2: Search screen for adding hedge members

Figure 3: Prospective hedge effectiveness result screen
Retrospective effectiveness tests
For compliance with IAS 39, retrospective effectiveness tests must be performed, using historical values, to allow the booking of hedge adjustments. In case there are not enough historical observations, values can be generated using various types of methods (e.g. using forward-looking scenarios or historical interest rates). The same testing methods are available as for prospective tests.

General ledger entries
Ambit Focus allows you to cover the entire process chain from the initiation of a hedge to the booking of hedge adjustments in the general ledger. All necessary results are stored in the database and can be accessed from there. Alternatively, text files can be generated and sent to the general ledger system. Users can define the exact format of these files, so that they can be read by most general ledger systems.

As well as being able to transfer results directly to the general ledger, the application offers reporting capabilities to help streamline daily processes. A report showing all active hedge relationships and their effectiveness at a glance can be generated as well as a report showing their profit contributions (e.g. hedge adjustments).

Closing and amortization
Finally, Ambit Focus will help manage the last phase of a hedge relationship. Hedge relationships can be closed for several reasons, including ineffectiveness and maturity, and the application not only allows you to document the closure (reason, user etc.) but will also amortize the hedge adjustment. For micro fair value hedging, this is achieved using the effective yield method; and for portfolio fair value, using the linear approach.

Besides the general management of the hedge life cycle, a proper hedge accounting solution must also be able to cope with any disturbances of the life cycle. To this end, Ambit Focus allows you to perform late designation and book correction events in a rapid and user-friendly way.

Why choose Ambit Focus?
Our solution provides the following benefits:

- Full integration of balance sheet management, empowering risk measurement across different departments
- Best of breed balance sheet management solution, enabling banks to take risk management beyond compliance and focus on performance
- Modular platform, allowing combinations of out of the box functionalities for:
  - ALM
  - Stochastic ALM
  - Liquidity Risk
  - Market Risk
  - Hedge Accounting
  - IFRS 9 Impairment and Credit Adjusted ALM
  - Funds Transfer Pricing
- Intuitive and user-friendly interface
- Multi-dimensional planning and reporting
About FIS' Ambit Risk & Performance

FIS' Ambit Risk & Performance Management suite of solutions gives you a centralized view of risk, liquidity, capital and profitability across the enterprise so that you can be prudent in your decision making yet strategic for maximized returns. Ambit Risk & Performance Management offers modular solutions for asset liability and market risk management, liquidity risk management, regulatory compliance and economic capital management, operational risk management and credit risk management.
For more information, visit www.fisglobal.com/ambit

About FIS' Risk Solutions

FIS' risk solutions cover collateral management, liquidity, asset and liability management, market and credit risk and capital management. As a complete solution suite that supports a firm's end to end risk management requirements, these solutions help aggregate risk data, set the risk appetite and forecast enterprise-wide risk activities and performance. This helps firms better understand and forecast regulatory impacts on funding, trading and asset allocation across all risk classes to lower total cost of ownership and drive competitive performance from compliance. For more information, please visit www.fisglobal.com/enterpriserisk

About FIS

FIS is a global leader in financial services technology, with a focus on retail and institutional banking, payments, asset and wealth management, risk and compliance, consulting and outsourcing solutions. Through the depth and breadth of our solutions portfolio, global capabilities and domain expertise, FIS serves more than 20,000 clients in over 130 countries. Headquartered in Jacksonville, Florida, FIS employs more than 53,000 people worldwide and holds leadership positions in payment processing, financial software and banking solutions. Providing software, services and outsourcing of the technology that empowers the financial world, FIS is a Fortune 500 company and is a member of Standard & Poor’s 500® Index. For more information about FIS, visit www.fisglobal.com

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