



# HEDGE ACCOUNTING

**FIS BALANCE SHEET MANAGER**  
**FORMERLY AMBIT FOCUS**

# 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 through 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.

FIS® Balance Sheet Manager (formerly 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.

## TIMELINES

IFRS 9 Financial Instruments is effective from **January 1st 2018**, with an option to be applied earlier. For hedge accounting, the standard offers the accounting policy choice of applying either the hedge accounting model defined in IFRS 9 or IAS 39 in its entirety, until the completion of the project on macro hedging.

Source: IFRS 9 Financial Instruments Project Summary, July 2014

The IASB's requirements are integrated throughout the modules in Balance Sheet Manager. 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 BALANCE SHEET MANAGER

Balance Sheet Manager provides support for the entire hedge management process as depicted below.

**Figure 1: Life cycle of hedge relationships**



## Identify hedge members

In Balance Sheet Manager 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 Balance Sheet Manager 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

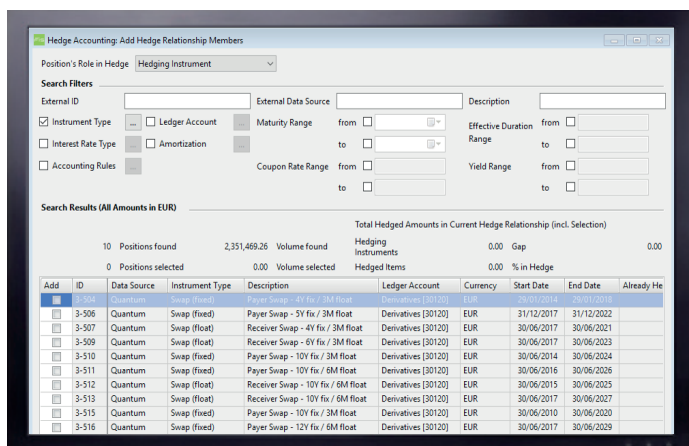
For a newly created hedge relationship to qualify for hedge accounting, the prospective effectiveness of the relationship must be assessed. Three different test methods are offered by Balance Sheet Manager to assess hedge effectiveness:

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

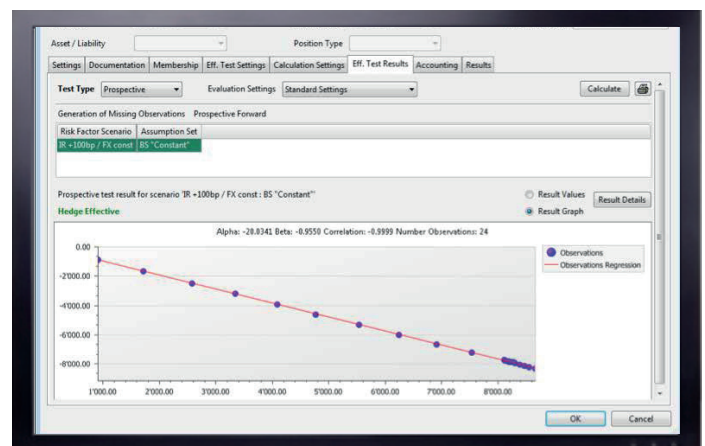
Within the application itself, users can define the limits of what they deem an effective hedge relationship. This allows for defining criteria that are in line with internal risk management policies.

Prospective effectiveness tests require both the hedged item and the hedging instrument to be projected into the future. Within Balance Sheet Manager 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

Balance Sheet Manager 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, Balance Sheet Manager 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, Balance Sheet Manager allows you to perform late designation and book correction events in a rapid and user-friendly way.

## Why choose Balance Sheet Manager?


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

FIS is a leading provider of technology solutions for merchants, banks and capital markets firms globally. Our employees are dedicated to advancing the way the world pays, banks and invests by applying our scale, deep expertise and data-driven insights. We help our clients use technology in innovative ways to solve business-critical challenges and deliver superior experiences for their customers. Headquartered in Jacksonville, Florida, FIS is a Fortune 500® company and is a member of Standard & Poor's 500® Index.

 [www.fisglobal.com](http://www.fisglobal.com)

 [getinfo@fisglobal.com](mailto:getinfo@fisglobal.com)

 [twitter.com/fisglobal](https://twitter.com/fisglobal)

 [linkedin.com/company/fis](https://linkedin.com/company/fis)