of the
Comptroller of the Currency
Administrator of National Banks
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Subject: Accounting for Derivatives and Hedging Activities
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To: Chief Executive Officers of National Banks, Department and Division Heads, and all Examining Personnel

Description: Message to Bankers\Examiners

institutions, FAS 133 will be effective beginning January 1, 2000. (It is required for fiscal years beginning after June 15, 1999.) However, institutions were permitted to adopt the new rule as early as July 1, 1998.

FAS 133 is a complex accounting standard that will have an important effect on the financial statements and accounting systems of many national banks. Most significantly, FAS 133 changes the definition of a derivative instrument. Banks that did not previously have derivatives may have financial instruments subject to this new standard. Regardless of whether a bank has derivatives, all institutions will be affected by the adoption of FAS 133 because of certain implementation provisions.

To help banks understand the implications of this new accounting standard, this Bulletin provides a brief overview of FAS 133 and identifies some of its key requirements. [Note: This guidance is not intended to be comprehensive; institutions are encouraged to obtain and review a copy of the standard and discuss its implications with their independent accountants.]

OVERVIEW

Used prudently, derivatives give banks an effective tool for managing risk. FAS 133 will affect the accounting for current risk management and investment strategies that use derivative instruments. The primary change is that the accounting concept of a "derivative" is redefined and detailed guidance is provided to determine which financial instruments fall under the scope of the new standard. Futures, forwards, options, swaps, and certain derivatives embedded in non-derivative instruments (e.g., structured notes) will be affected.

The standard requires that all derivatives be recorded as assets or liabilities at fair value. As in current practice, an institution may elect to use "hedge accounting" [Note: "Hedge accounting" is a special accounting treatment designed to enable an institution to recognize related fair value gains and losses simultaneously in income.] for derivatives that meet specific qualifying criteria. However, FAS 133 significantly changes the hedge accounting procedure, requiring that any ineffectiveness in a hedge strategy be recognized in income during the current period. The standard establishes three new classifications of hedges, each with its own accounting treatment:

- Fair Value -- hedges of the risk resulting from changes in the fair value of a recorded asset, liability, or unrecognized firm commitment (a binding agreement to enter into a transaction with an unrelated party). If specified criteria are met, an institution can use a derivative in a fair value hedge to attempt to "lock in" the amount of an unrecognized firm commitment or to hedge the change in fair value of an asset or liability. Examples of fair value hedges could include synthetically converting a fixed-rate liability (e.g., debt) to a variable-rate liability through an interest rate swap or using treasury rate futures contracts to hedge the fair value of an available-for-sale,

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fixed-rate debt security. Under a fair value hedge, the change in fair value of the derivative is recognized in earnings together with the change in the fair value of the hedged item attributable to the risk being hedged.

- Cash Flow -- hedges of the risk resulting from changes in the amount of future cash flows (e.g., interest payments on debt or interest income on loans) or forecasted transactions. If the specified criteria are met, an institution can use a derivative in a cash flow hedge to "lock in" the amount of a future cash inflow or outflow. Examples of cash flow hedges could include using an interest rate swap to synthetically convert the interest payments on a variable-rate loan to a fixed amount or using a forward rate agreement to lock in the interest rate on the forecasted issuance of fixed-rate debt. Under a cash flow hedge, the effective portion of the change in fair value of the derivative is recognized in a separate component of equity called "Other Comprehensive Income." (This is similar to the treatment of the unrealized gains and losses on available-for-sale securities.) The ineffective portion of the hedge is reported in earnings.
- Foreign Currency -- hedges of the risk resulting from changes in foreign currency values. If specified criteria are met, an institution can use a derivative in a foreign currency fair value hedge or cash flow hedge. For example, the use of a derivative to "lock in" the U.S. dollar cost of a foreign currency transaction would be considered a "foreign currency" hedge. Examples of foreign currency hedges could include using a forward contract to hedge the amount of a cash outflow on an anticipated foreign currency-denominated transaction, or purchasing a put option to hedge changes in the fair value of an available-for-sale foreign currency-denominated debt security. The accounting for a foreign currency hedge depends on the transaction, but will be treated similar to either a fair value hedge or a cash flow hedge.

Consistent with current practice, derivatives used for trading or that do not qualify for hedge accounting will be marked to fair value, with changes in fair value recognized in current income.

In all cases, FAS 133 requires derivatives designated for hedge accounting to be linked to the specific assets, liabilities, firm commitments, or forecasted transactions being hedged. This transaction-by-transaction approach does not allow hedge accounting if one or more derivatives are used to hedge diverse groups of assets and liabilities.

SPECIAL CONSIDERATIONS

Embedded Derivatives

FAS 133 introduces new accounting requirements for certain derivatives that are embedded within another financial instrument. If the derivative is not "clearly or closely related" to the economic characteristics of the host, the hybrid instrument must be split into its derivative and nonderivative components, with the derivative portion accounted for separately at fair value. The standard provides many examples of financial instruments that would be considered to have embedded derivatives, including some structured notes that banks often hold in their investment portfolios. This requirement applies to any hybrid instruments acquired or modified after January 1, 1998.

For some complex embedded derivatives, determining fair value may be difficult. The standard indicates that if the derivative cannot be reliably measured, the entire instrument should be marked to market with changes in fair value recognized in income.

One-time Opportunity to Transfer Securities from Held-to-Maturity

Because the new accounting requirements may affect an institution's risk management strategies relating to investments, the standard permits a one-time transfer of any held-to-maturity security into the available-for-sale or trading categories. Such transfers, performed at the date of initial application of FAS 133, will not call into question an institutions' ability to hold other debt securities to maturity in the future.

This opportunity to transfer securities from held-to-maturity is available to all institutions, including those banks that do not have derivative instruments. However, because of the complexity of the standard and its potential implications for embedded derivatives, institutions should carefully consider all of the new requirements before implementation. Institutions are not permitted to adopt this provision on a selective basis. Upon adoption, FAS 133 must be implemented in its entirety.

IMPLEMENTATION CONSIDERATIONS

Because of the complexity of the standard, institutions should begin planning for the implementation of FAS 133 as early as possible. The impact of implementation will be greatest for institutions that have a large number of derivative instruments, but smaller institutions may also be affected by the new rule.

National banks should consider the following issues before adoption:

- Scope Institutions should identify which of their financial instruments meet FAS 133's definition of a derivative. This analysis should also consider whether derivatives embedded in another instrument must be accounted for separately.
- Effect on Existing Risk Management Strategies After identifying current hedging strategies, an institution should consider how the accounting will change under FAS 133. For example, will the current strategy still qualify for hedge accounting, if so, what type of hedge would it be considered under FAS 133 (fair value, cash flow, or foreign currency)? As the new accounting standard may affect an institution's net income, total assets and/or capital, banks should also consider what the impact will be on performance measures (e.g. return on assets, return on equity).
- For existing strategies that do not qualify for hedge accounting under FAS 133, the bank should consider if there are alternative methods that would achieve the desired risk management objective.
- Documentation Although conceptually similar to existing requirements, FAS 133 requires more detailed documentation to qualify for hedge accounting. Specifically, to qualify for hedge accounting, institutions must document their risk management strategy and objectives for undertaking a hedge. They also need to specify at the beginning of the hedging transaction how they will assess the degree to which the hedge was effective. If an institution wishes to carryover hedge accounting treatment when FAS 133 is adopted, all documentation requirements must be met.
- System Implications FAS 133 may require enhancements to existing bank accounting systems. For example, an institution may need the capability to 1) determine the fair value of certain embedded derivatives, 2) identify the change in fair value of the hedged items due to the specific risk being hedged, 3) compute the ineffective portion of derivative hedges, and 4) track deferred gains and losses placed in equity (for cash flow hedges).
- Disclosures FAS 133 requires detailed disclosures about derivatives used for hedging. Institutions should ensure that they have the necessary procedures and systems in place to conform with these requirements. Further, SEC registrants that do not adopt FAS 133 early, should discuss the impact that FAS 133 will have in the footnotes to their financial statements.

REGULATORY CONSIDERATIONS

The OCC and the other federal bank regulatory agencies are considering the impact of FAS 133 on regulatory reporting and capital requirements. Specific considerations include whether additional information will be required in the call reports and how to treat deferred gains and losses that are placed in equity (resulting from cash flow hedges) for regulatory capital. Additional guidance on these issues will be provided in the future.

For more information on FAS 133, call Thomas Rees or Gene Green, Office of the Chief Accountant at (202) 874-5180.

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