Certificate in Hedge Accounting Fundamentals (Sweden)

Introduction to Hedge Accounting

Accounting Hedge Ratio – concept: The proportion of the hedged item that is covered by the hedge. Related terms: hedge effectiveness, risk exposure. Explanation: The accounting hedge ratio determines how much of the forecasted transaction or cash flow is offset by the hedging instrument. It is expressed as a percentage or a fraction and must be documented at inception and reviewed regularly. Example: A company expects to purchase €5 million of raw material in six months. It enters into a forward contract for €3 million. The accounting hedge ratio is 60 % (3 / 5). Practical application: Setting the ratio guides the measurement of hedge effectiveness and ensures the hedge qualifies for hedge accounting under IFRS 9. Challenges: Changes in the forecasted amount or market conditions may require re-balancing the hedge or adjusting the ratio, which can be administratively intensive.

Basis Risk – concept: The risk that the hedge's performance will not perfectly offset the exposure because of differences in underlying variables. Related terms: mismatch risk, cash flow hedge. Explanation: Basis risk arises when the hedged item and the hedging instrument are not perfectly correlated, for example, when a company hedges a commodity price using a related but not identical futures contract. Example: An airline hedges jet fuel price risk with crude oil futures; the two prices often move together but not identically, creating basis risk. Practical application: Companies assess basis risk during hedge design to decide whether the hedge qualifies under IFRS 9. Challenges: Quantifying basis risk can be complex, especially for exotic or ill-liquid instruments, and may affect the hedge's effectiveness assessment.

Cash Flow Hedge – concept: A hedge of exposure to variability in cash flows attributable to a particular risk. Related terms: fair value hedge, hedge effectiveness. Explanation: Under IFRS 9, a cash flow hedge is used when the objective is to protect future cash flows, such as anticipated purchases or sales, from fluctuations in interest rates, foreign exchange rates, or commodity prices. The effective portion of the hedge's gain or loss is recognized in other comprehensive income (OCI) and later re-classified to profit or loss when the hedged transaction affects earnings. Example: A Swedish exporter expects to receive USD 10 million in three months and enters into a forward contract to lock in the exchange rate. Practical application: Cash flow hedges allow firms to smooth earnings volatility due to currency movements. Challenges: Maintaining hedge effectiveness, documenting the relationship, and ensuring the forecasted transaction remains probable can be demanding.

Derivative – concept: A financial instrument whose value derives from an underlying asset, rate, or index. Related terms: forward contract, option, swap. Explanation: Derivatives are commonly used for hedging because they can be tailored to offset specific risks. They include forwards, futures, options, and swaps, each with distinct payoff structures. Example: A company purchases a 12-month interest rate swap to convert floating-rate debt to fixed-rate, thereby hedging interest rate risk. Practical application: Derivatives enable precise matching of risk profiles, often at lower cost than physical asset acquisition. Challenges: Valuation complexity, accounting treatment, and regulatory compliance require robust systems and expertise.

Effective Hedge – concept: A hedge that meets the criteria for hedge accounting under IFRS 9. Related terms: hedge effectiveness, prospective testing. Explanation: To be considered effective, a hedge must demonstrate that changes in the fair value or cash flows of the hedging instrument offset changes in the hedged item within an acceptable range (commonly 80-125 %). Effectiveness is assessed both prospectively and retrospectively. Example: A company's foreign currency forward contract offsets the anticipated cash flows of a foreign sales invoice, and the ratio of changes falls within the 80-125 % range. Practical application: Effective hedges allow deferred recognition of gains/losses in OCI, reducing earnings volatility. Challenges: Continuous monitoring, documentation, and statistical testing can be resource-intensive.

Fair Value Hedge – concept: A hedge of exposure to changes in the fair value of a recognized asset, liability, or firm commitment. Related terms: cash flow hedge, hedge accounting. Explanation: In a fair value hedge, both the hedging instrument and the hedged item are remeasured at each reporting date, and the effective portion of the gain or loss on the hedging instrument is recognized in profit or loss alongside the hedged item's fair-value changes. Example: A company holds a fixed-rate bond and enters into an interest rate swap to hedge the bond's fair-value exposure to interest-rate changes. Practical application: Fair value hedges provide a transparent view of the net effect of market movements on the balance sheet. Challenges: Determining the portion of the hedged item that is attributable to the hedged risk and separating it from other factors can be intricate.

Forecasted Transaction – concept: A transaction that is expected to occur in the future, such as a purchase, sale, or receipt. Related terms: cash flow hedge, hedge documentation. Explanation: For hedge accounting, the forecasted transaction must be probable and reliably estimable. It serves as the basis for designating a hedge and for assessing effectiveness. Example: A manufacturer plans to buy copper in nine months; the expected purchase is a forecasted transaction. Practical application: Documenting the forecast allows the entity to qualify the hedge under IFRS 9. Challenges: Changes in timing, quantity, or price can jeopardize hedge qualification, requiring re-assessment or hedge discontinuation.

Hedge Documentation – concept: The formal record that outlines the hedging relationship, risk management objective, and strategy. Related terms: hedge effectiveness, risk management policy. Explanation: Documentation must be prepared at inception and include the hedged item, hedging instrument, the nature of the risk, the method of assessing effectiveness, and the accounting treatment. Example: A firm's risk management manual specifies that all foreign currency exposures will be hedged using forward contracts, and each hedge is documented with a risk register entry. Practical application: Proper documentation is a prerequisite for hedge accounting treatment. Challenges: Maintaining up-to-date documentation across multiple hedges and ensuring consistency with internal policies can be burdensome.

Hedge Effectiveness – concept: The degree to which changes in the fair value or cash flows of the hedging instrument offset changes in the hedged item. Related terms: effective hedge, prospective testing. Explanation: Effectiveness is measured using statistical methods such as regression analysis, dollar-offset approach, or critical-value approach, and must fall within the 80-125 % range. Example: A regression of changes in a forward contract's value against changes in a forecasted foreign currency invoice yields an R-squared of 0.92, Indicating strong effectiveness. Practical application: Demonstrating effectiveness

enables the entity to record gains/losses in OCI for cash flow hedges. Challenges: Selecting appropriate testing methods, handling non-linear relationships, and meeting documentation requirements can be complex.

Hedge Instrument – concept: The derivative or non-derivative financial instrument used to offset exposure. Related terms: hedged item, derivative. Explanation: The hedge instrument must be designated at inception and must be capable of offsetting the specific risk of the hedged item. Example: A company uses a Euro-to-Swedish-krona forward contract as the hedge instrument for an upcoming Euro-denominated purchase. Practical application: Choosing the right instrument influences cost, liquidity, and accounting treatment. Challenges: Market liquidity, credit risk, and valuation complexities must be evaluated.

Hedged Item – concept: The asset, liability, forecasted transaction, or firm commitment being protected from risk. Related terms: hedge instrument, risk exposure. Explanation: The hedged item is identified in the risk management strategy and must be measurable in monetary terms. Example: A firm's anticipated receipt of USD 5 million from a customer is a hedged item for foreign exchange risk. Practical application: Accurate identification ensures appropriate hedge accounting classification. Challenges: When the hedged item is a firm commitment, estimating its fair value and future cash flows may be difficult.

IFRS 9 – concept: International Financial Reporting Standard that governs accounting for financial instruments, including hedge accounting. Related terms: IAS 39, fair value hedge. Explanation: IFRS 9 replaced IAS 39 and introduced a more principles-based approach, allowing more entities to apply hedge accounting if they meet effectiveness criteria and document the hedge. Example: A Swedish company adopts IFRS 9 and reclassifies its existing hedges under the new standard. Practical application: IFRS 9 aligns accounting with risk management practices, improving transparency. Challenges: Transitioning from IAS 39 requires restating prior periods, adjusting systems, and training staff.

Interest Rate Risk – concept: The exposure to fluctuations in market interest rates that affect cash flows or fair values. Related terms: interest rate swap, fair value hedge. Explanation: Companies with floating-rate debt or assets are vulnerable to changes in interest rates, which can impact financing costs or the value of investments. Example: A firm with a variable-rate loan enters into a swap to receive fixed and pay floating, thereby fixing its interest expense. Practical application: Hedging interest rate risk stabilizes budgeting and financial planning. Challenges: Basis risk may arise if the swap's reference rate differs from the loan's rate, and effectiveness testing must consider the impact of rate changes on both instruments.

Liquidity Risk – concept: The risk that a firm cannot meet its cash-flow obligations due to insufficient liquid assets. Related terms: cash flow hedge, risk management. Explanation: While not directly a hedge accounting term, liquidity risk influences the choice of hedging instruments, as illiquid derivatives may exacerbate cash constraints. Example: A company avoids long-dated forward contracts in a thinly traded currency to preserve liquidity. Practical application: Assessing liquidity risk ensures that hedging strategies do not impair working-capital needs. Challenges: Balancing effective risk mitigation with the availability of suitable instruments can limit hedging options.

Mark-to-Market (MTM) – concept: The practice of revaluing a financial instrument at its current market price. Related terms: fair value, valuation. Explanation: For derivatives used in hedges, MTM ensures that

gains and losses are recognized promptly, facilitating accurate measurement of hedge effectiveness. Example: At each month-end, a forward contract is revalued to reflect the prevailing exchange rate, and the resulting MTM adjustment is recorded. Practical application: MTM provides timely information for risk monitoring and financial reporting. Challenges: Inactive markets may require valuation techniques such as observable inputs or model-based estimates, increasing complexity.

Non-Derivative Hedging Instrument – concept: A financial instrument that is not a derivative but can be used as a hedge, such as a loan or a foreign currency receivable. Related terms: fair value hedge, cash flow hedge. Explanation: IFRS 9 permits non-derivative instruments to be designated as hedging instruments if they meet the criteria for effectiveness and documentation. Example: A company uses a foreign-currency-denominated loan to hedge an anticipated foreign-currency receipt, effectively offsetting the exposure. Practical application: Non-derivative hedges can reduce reliance on derivatives and lower transaction costs. Challenges: Valuing non-derivative instruments for hedge accounting purposes may be more involved than for standard derivatives.

Offsetting Asset – concept: An asset held to offset the risk of another asset, often used in hedge accounting. Related terms: hedged item, risk mitigation. Explanation: The offsetting asset's performance is expected to move inversely to the risk exposure, reducing overall volatility. Example: Holding a treasury bond to offset interest-rate risk on a floating-rate loan. Practical application: Offsetting assets can qualify for hedge accounting if properly documented. Challenges: Correlation may weaken over time, affecting hedge effectiveness.

Prospective Hedge Effectiveness Testing – concept: Forward-looking assessment of whether a hedge is expected to be effective in the future. Related terms: retrospective testing, hedge effectiveness. Explanation: Entities must perform prospective testing at each reporting date to confirm that the hedge is likely to remain within the 80-125 % effectiveness range over its remaining life. Example: Using forecasted market data, a company projects that its forward contract will continue to offset the foreign currency exposure of an upcoming sale. Practical application: Prospective testing ensures ongoing compliance with hedge accounting standards. Challenges: Requires reliable forecasts and may involve statistical modeling, increasing operational workload.

Qualifying Hedge – concept: A hedge that satisfies the criteria set out in IFRS 9 for hedge accounting. Related terms: effective hedge, hedge documentation. Explanation: To qualify, the hedge must be designated, documented, and demonstrably effective. Example: A cash flow hedge of a forecasted purchase that meets the 80-125 % effectiveness test qualifies as a qualifying hedge. Practical application: Qualifying hedges enable deferred OCI recognition, reducing earnings volatility. Challenges: Failure to meet any criterion, such as insufficient documentation, disqualifies the hedge, forcing immediate profit-or-loss recognition.

Risk Management Objective – concept: The strategic goal an entity seeks to achieve by managing financial risk. Related terms: hedge strategy, risk appetite. Explanation: The objective may be to stabilize cash flows, protect profit margins, or meet regulatory capital requirements. Example: A firm's objective is to eliminate foreign-exchange volatility on its European sales. Practical application: Clearly defined objectives guide the

selection of hedging instruments and accounting treatment. Challenges: Objectives may evolve with market conditions, requiring periodic review and adjustment of hedging policies.

Risk Management Policy – concept: The formal statement outlining how an organization identifies, assesses, and mitigates risk. Related terms: hedge documentation, risk management objective. Explanation: The policy sets the framework for hedge accounting, specifying eligible hedges, effectiveness thresholds, and reporting responsibilities. Example: A company's policy mandates that all material foreign-exchange exposures be hedged using forwards or options, with effectiveness testing performed quarterly. Practical application: The policy provides governance and ensures compliance with IFRS 9. Challenges: Keeping the policy aligned with evolving market practices and regulatory updates requires continuous oversight.

Scenario Analysis – concept: A technique for evaluating the impact of different market conditions on hedging outcomes. Related terms: stress testing, hedge effectiveness. Explanation: By modeling alternative interest-rate, currency, or commodity price paths, entities can assess the robustness of their hedges. Example: A firm models a 30 % depreciation of the Euro against the SEK to determine whether its forward contracts remain effective. Practical application: Scenario analysis supports prospective effectiveness testing and informs risk-mitigation decisions. Challenges: Selecting realistic scenarios and integrating the results into accounting judgments can be resource-intensive.

Swap – concept: A derivative contract in which two parties exchange cash flows based on different underlying variables, such as interest rates or currencies. Related terms: interest rate swap, currency swap. Explanation: Swaps are widely used for hedging because they can be customized to match the exposure's terms. Example: A company swaps floating-rate loan payments for fixed-rate payments to hedge interest-rate risk. Practical application: Swaps can be designated as fair-value or cash-flow hedges, depending on the risk being mitigated. Challenges: Counterparty credit risk, valuation complexity, and documentation requirements must be managed.

Valuation – concept: The process of determining the fair value of a financial instrument. Related terms: mark-to-market, fair value. Explanation: Accurate valuation is essential for measuring gains and losses on hedging instruments and for assessing hedge effectiveness. Example: A valuation model uses market quotes for the underlying currency pair to calculate the fair value of a forward contract. Practical application: Consistent valuation methods support reliable financial reporting. Challenges: Inactive markets may necessitate model-based valuations, which require significant judgment and documentation.

Variance-Reduction Technique – concept: A statistical method used to improve the precision of hedge effectiveness testing. Related terms: Monte Carlo simulation, regression analysis. Explanation: Techniques such as antithetic variates or control variates can reduce the sampling error in effectiveness calculations. Example: Applying antithetic variates in a Monte Carlo simulation of foreign-exchange rates yields tighter confidence intervals for the hedge effectiveness estimate. Practical application: Enhanced precision supports compliance with the 80-125 % effectiveness range. Challenges: Implementation may demand specialized software and statistical expertise.

Volatility – concept: The degree of variation of a market price over time, often measured by standard deviation. Related terms: risk exposure, hedge effectiveness. Explanation: Higher volatility increases the

potential benefit of hedging but also raises the difficulty of maintaining hedge effectiveness. Example: A commodity with price volatility of 30 % per annum may prompt a firm to use options rather than forwards to manage downside risk. Practical application: Volatility informs the selection of hedging instruments and the setting of effectiveness thresholds. Challenges: Forecasting volatility accurately is challenging, and mis-estimation can lead to ineffective hedges.

Yield Curve – concept: A graphical representation of interest rates across different maturities. Related terms: interest rate swap, forward rate agreement. Explanation: The shape of the yield curve influences the pricing of interest-rate derivatives and the assessment of hedge effectiveness for fixed-income instruments. Example: A steepening yield curve may affect the fair-value changes of a bond and its corresponding interest-rate swap. Practical application: Understanding the yield curve helps in designing effective fair-value hedges for interest-rate exposure. Challenges: Rapid shifts in the curve can introduce basis risk and complicate effectiveness testing.

Zero-Cost Collar – concept: A hedging strategy that combines a long put option and a short call option to limit currency exposure without upfront cost. Related terms: option, currency hedge. Explanation: The premium received from selling the call offsets the premium paid for the put, resulting in a net-zero cash outlay. Example: A Swedish exporter purchases a EUR / SEK put with a strike of 10.5 And sells a call at 11.5, Establishing a protective band around the exchange rate. Practical application: Zero-cost collars provide downside protection while capping upside upside, useful for budgeting. Challenges: The upside limitation may be undesirable if the currency moves favorably, and the hedge must still meet effectiveness criteria.

Accounting Impact of Hedge Discontinuation – concept: The financial reporting consequences when a hedge no longer meets qualifying criteria. Related terms: hedge effectiveness, OCI reclassification. Explanation: Upon discontinuation, any accumulated gains or losses in OCI are reclassified to profit or loss, and the hedging instrument is accounted for at fair value with changes recognized immediately. Example: A forward contract is discontinued because the underlying forecasted transaction is canceled; the accumulated OCI is transferred to earnings. Practical application: Proper handling avoids misstatement of earnings. Challenges: Identifying the exact point of discontinuation and ensuring timely reclassification can be operationally demanding.

Back-to-Back Hedge – concept: A hedging structure where an entity simultaneously enters into offsetting contracts to neutralize exposure. Related terms: risk mitigation, basis risk. Explanation: By matching the terms of the hedge instrument with the exposure, the entity reduces residual risk. Example: A firm that sells a commodity forwards its production and simultaneously buys a forward to cover the anticipated purchase, creating a back-to-back hedge. Practical application: This approach can simplify accounting, as the net exposure is minimal. Challenges: Transaction costs and the need for precise alignment increase complexity.

Cash Flow Forecast – concept: A projection of future cash inflows and outflows, often used to identify hedging needs. Related terms: forecasted transaction, risk management objective. Explanation: Accurate forecasts enable the identification of exposures that can be hedged, such as anticipated foreign-currency receipts. Example: A company forecasts SEK 50 million of sales in Q4, of which SEK 20 million is expected in USD, prompting a cash flow hedge. Practical application: The forecast provides the basis for hedge

documentation and effectiveness testing. Challenges: Forecast errors can lead to mismatches, requiring hedge rebalancing.

Contingent Hedge – concept: A hedge that is activated only if a specific contingency occurs, such as a contract signing. Related terms: forecasted transaction, hedge documentation. Explanation: The hedge is designated before the contingency is certain, but effectiveness testing may be deferred until the contingency resolves. Example: A company signs a letter of intent to purchase foreign raw material; it enters into a forward contract contingent upon the final contract being signed. Practical application: Contingent hedges enable proactive risk management. Challenges: Accounting treatment can be complex, as the hedge may not qualify until the contingency becomes probable.

Currency Forward – concept: A non-deliverable or deliverable contract to exchange a specified amount of foreign currency at a predetermined rate on a future date. Related terms: foreign exchange risk, cash flow hedge. Explanation: Forward contracts lock in exchange rates, eliminating uncertainty about future cash flows denominated in foreign currency. Example: A Swedish importer purchases a EUR/SEK forward to secure the rate for a €1 million invoice due in six months. Practical application: Forward contracts are the most common tool for hedging transaction risk. Challenges: Credit risk with the counterparty and the need for daily mark-to-market adjustments.

Derivatives Accounting Software – concept: Specialized systems that automate valuation, effectiveness testing, and reporting of hedging instruments. Related terms: valuation, hedge documentation. Explanation: The software integrates market data feeds, performs statistical tests, and generates journal entries compliant with IFRS 9. Example: An ERP module automatically revalues interest-rate swaps and posts the OCI entries for cash flow hedges. Practical application: Automating calculations reduces manual errors and speeds up the reporting cycle. Challenges: Implementation costs, data quality, and maintaining alignment with regulatory updates can be significant.

Effective Date – concept: The date on which a hedge is formally designated and the hedging relationship begins. Related terms: hedge documentation, prospective testing. Explanation: From the effective date forward, the entity must perform effectiveness testing and record hedge accounting entries. Example: A forward contract signed on 1 January is designated as a hedge on 5 January; the effective date is 5 January. Practical application: The effective date marks the start of the accounting treatment and the point at which the hedge must meet all qualifying criteria. Challenges: Delays between contract signing and designation can affect the timing of OCI recognition.

Foreign Exchange Risk – concept: Exposure to changes in currency exchange rates that affect cash flows or the value of assets and liabilities. Related terms: currency forward, cash flow hedge. Explanation: Companies with cross-border operations face transaction risk (e.G., Foreign sales) and translation risk (e.G., Foreign-currency-denominated assets). Example: A Swedish exporter invoicing in USD is exposed to USD/SEK fluctuations. Practical application: Hedging with forwards, options, or swaps mitigates earnings volatility. Challenges: Selecting the appropriate instrument and maintaining hedge effectiveness over the exposure period.

Forward Rate Agreement (FRA) – concept: An over-the-counter contract to lock in an interest rate for a

future period. Explanation: FRAs are used to hedge interest-rate exposure on short-term borrowing or lending. Example: A firm enters into an FRA to secure a 3-month LIBOR rate for a future loan. Practical application: FRAs provide precise rate locking without the need for a full swap. Challenges: Limited market depth for certain tenors can affect pricing and liquidity.

Hedging Strategy Review – concept: Periodic evaluation of the effectiveness and relevance of hedging policies and practices. Related terms: risk management policy, scenario analysis. Explanation: Reviews assess whether hedges continue to meet objectives, comply with accounting standards, and align with the entity's risk appetite. Example: An annual board meeting includes a review of all active hedges, their performance, and any needed adjustments. Practical application: Regular reviews support governance and continuous improvement. Challenges: Gathering accurate data and coordinating across finance, treasury, and audit functions can be demanding.

Hedging Cost – concept: The expense incurred to implement a hedge, including premiums, transaction fees, and bid-ask spreads. Related terms: zero-cost collar, derivative. Explanation: Hedging costs affect the net benefit of risk mitigation and must be considered in the overall risk-adjusted return analysis. Example: Purchasing a currency option costs a premium of 0.5 % Of the notional amount. Practical application: Companies weigh hedging costs against the potential impact of unhedged risk on earnings. Challenges: Hidden costs, such as valuation adjustments or accounting fees, may reduce the net advantage of hedging.

Impairment of Hedging Instruments – concept: The reduction in carrying amount of a hedging instrument due to credit risk or market deterioration. Related terms: counterparty risk, fair value hedge. Explanation: If a derivative's fair value declines significantly and the decline is not expected to be recovered, an impairment loss is recognized in profit or loss. Example: A forward contract's fair value falls to near zero due to a counterparty's credit downgrade, prompting an impairment write-down. Practical application: Impairment accounting ensures that the financial statements reflect the true economic value of hedges. Challenges: Determining recoverable amounts and distinguishing temporary fair-value fluctuations from permanent impairments can be complex.

Interest Rate Cap – concept: An option that sets a maximum interest rate payable on a floating-rate loan. Related terms: interest rate risk, derivative. Explanation: The cap protects the borrower from rising rates while allowing benefit from rate declines. Example: A company purchases a cap with a strike of 4 % on its 3-year floating-rate loan. Practical application: Caps are used as cash-flow hedges to limit interest expense variability. Challenges: Premium costs and the need to assess hedge effectiveness for the capped portion.

Liquidity Hedge – concept: A hedge designed to ensure that cash is available to meet short-term obligations. Related terms: cash flow hedge, risk management objective. Explanation: By locking in financing rates or currency amounts, a liquidity hedge reduces uncertainty about cash availability. Example: A firm enters into a short-term foreign-currency forward to secure the funds needed for an upcoming import. Practical application: Liquidity hedges support working-capital planning. Challenges: Short-dated instruments may require frequent roll-overs, increasing transaction costs.

Mark-to-Market Volatility Adjustment – concept: An additional allowance for fluctuations in the MTM value of a hedging instrument. Related terms: valuation, fair value hedge. Explanation: Some entities apply a

volatility buffer to smooth OCI recognition for cash-flow hedges, especially when market prices are highly volatile. Example: Adding a 5 % volatility adjustment to the MTM of an FX forward to reduce OCI swings. Practical application: This approach can align accounting results with risk-management expectations. Challenges: The adjustment must be justified and consistently applied, and may be scrutinized by auditors.

Non-Linear Hedge – concept: A hedge that does not have a linear relationship with the underlying exposure, such as options. Related terms: option, basis risk. Explanation: Non-linear hedges provide asymmetric protection, limiting downside while allowing upside participation. Example: Purchasing a put option on a commodity price provides protection if prices fall but leaves the company exposed to gains if prices rise. Practical application: Non-linear hedges are useful when the entity wants to cap losses without fully eliminating upside potential. Challenges: Measuring effectiveness is more complex, and the 80-125 % range may be difficult to achieve.

Offsetting Transaction – concept: A transaction that neutralizes the effect of another, often used in hedge accounting to demonstrate effectiveness. Explanation: The offsetting transaction should have cash-flow characteristics that mirror the hedged exposure. Example: Receiving a foreign currency payment (offsetting transaction) that matches the amount of a forward contract (hedge instrument). Practical application: Demonstrating the offset helps satisfy documentation and effectiveness criteria. Challenges: Timing mismatches or partial offsets can introduce residual risk.

Risk Appetite – concept: The amount and type of risk an organization is willing to pursue or retain. Related terms: risk management objective, hedge strategy. Explanation: The appetite influences decisions on which exposures to hedge and to what extent. Example: A firm with a low risk appetite may hedge 100 % of its foreign-exchange exposure, while a higher-risk-tolerant firm may hedge only 60 %. Practical application: Aligning hedging activities with risk appetite ensures consistency across the enterprise. Challenges: Quantifying appetite and translating it into actionable limits requires governance structures.

Swap Spread – concept: The difference between the swap rate and the yield on a comparable government bond. Related terms: interest rate swap, yield curve. Explanation: The spread reflects credit risk, liquidity, and market demand, affecting the pricing of swaps used in hedges. Example: If the 5-year swap rate is 1.5 % And the 5-year government bond yield is 0.8 %, The swap spread is 70 bps. Practical application: Understanding the spread helps in assessing the cost of a fair-value hedge. Challenges: Spreads can widen unexpectedly, influencing hedge effectiveness and valuation.

Time-Zero Hedge Effectiveness Test – concept: An initial assessment of whether a hedge is expected to be effective when first designated. Related terms: prospective testing, hedge documentation. Explanation: At inception, the entity must demonstrate that the anticipated relationship between the hedging instrument and the hedged item falls within the effectiveness range. Example: Using historical volatility data, a company projects that its forward contract will offset the cash-flow variability of an upcoming sale within 85-115 %. Practical application: Passing the time-zero test allows immediate hedge accounting treatment. Challenges: Limited historical data for new markets may make the projection uncertain.

Underlying Asset – concept: The financial or non-financial item that determines the payoff of a derivative. Related terms: derivative, risk exposure. Explanation: The characteristics of the underlying asset, such as

price volatility and liquidity, influence the choice of hedging instrument. Example: The underlying asset of a currency forward is the foreign exchange rate between EUR and SEK. Practical application: Selecting an appropriate underlying ensures the hedge aligns with the exposure. Challenges: Mismatches between the underlying and the actual exposure can create basis risk.

Value-at-Risk (VaR) – concept: A statistical measure that estimates the maximum loss over a defined period at a given confidence level. Related terms: risk management, scenario analysis. Explanation: VaR is used to quantify the potential impact of market movements on hedging portfolios. Example: A treasury calculates that its FX exposure has a 1-day VaR of SEK 2 million at 95 % confidence. Practical application: VaR informs the sizing of hedges and capital allocation. Challenges: VaR assumes normal market conditions and may underestimate tail risk; reliance on historical data can be misleading during volatile periods.

Yield Curve Risk – concept: The exposure to changes in the shape or level of the yield curve affecting interest-rate-sensitive assets and liabilities. Explanation: Shifts in the yield curve can alter the fair value of bonds and swaps, influencing hedge effectiveness. Example: A steepening curve increases the value of a long-duration bond while decreasing the value of a corresponding swap, potentially causing a mismatch. Practical application: Hedging strategies may include using swaps of different tenors to match the exposure profile. Challenges: Managing multiple yield-curve risk factors adds complexity to effectiveness testing.

Zero-Coupon Bond Hedge – concept: A hedge that uses a zero-coupon bond to offset the fair-value changes of a liability or asset. Related terms: fair value hedge, interest rate risk. Explanation: Zero-coupon bonds have no periodic interest payments, making them useful for matching the timing of cash-flow exposures. Example: A company hedges a future fixed-rate payment by buying a zero-coupon bond maturing on the same date. Practical application: The bond's price sensitivity aligns with the liability's fair-value changes. Challenges: Market availability may be limited, and valuation requires discounting at appropriate rates.