International Forum of Accounting Standard-Setters

Macro hedging – A new approach to accounting for open portfolios

Purpose

1. This paper presents the following for discussion:

   A. known issues in accounting for open portfolios of financial instruments;

   B. the existing IFRS accounting available for open portfolios of financial instruments; and

   C. preliminary comments on the IASB's forthcoming Discussion Paper (DP) on macro hedge accounting (based on IASB staff papers to date).

2. The intention is for members to consider the above matters and share initial thinking, in preparation for the forthcoming issuance of the DP.

Questions for discussion:

1. Do members agree with the known issues set out in (A);
2. To what extent is IAS 39 'macro-hedge accounting' used in member jurisdictions?
3. Are members aware of any accounting approaches applied to open portfolios other than those outlined in (B); and
4. Do members have any comments on (C) or additional comments concerning the IASB DP?

Background

IFRS 9 project - replacement of IAS 39

3. Financial instruments are currently accounted for in accordance with IAS 39 *Financial Instruments Recognition and Measurement*, and IAS 32 *Financial Instruments: Presentation*. The IASB is replacing IAS 39 with IFRS 9 *Financial Instruments* in a phased approach.

4. In its May 2012 Board meeting the IASB decided that accounting for 'macro-hedging' would be scoped out of the IFRS 9 project. Furthermore, the IASB decided to issue a Discussion Paper (DP) on macro hedging rather than an exposure draft to enable it to seek views from constituents on a range of alternatives and address other risks in addition to interest rate risk.

5. The IASB is expected to issue the DP on macro hedge accounting in Q1 2014. The DP is expected to propose a new 'portfolio revaluation approach' for accounting for open portfolios of financial instruments for which 'dynamic risk management' is used.

(A) Known Issues in Accounting for Open Portfolios

IAS 39 hedge accounting

6. IAS 39 hedge accounting requirements are highly 'rules-based'. Due to the many rules and restrictions of the requirements it is generally considered difficult (or sometimes impossible) to align IAS 39 accounting with an entity's view of the underlying economics and risk management practices. This is particularly the case when a 'hedging relationship' is not a one-to-one relationship between a hedging instrument and a hedged item[1].

7. In response to feedback on the first version of IAS 39 it issued, the IASB identified that there were particular difficulties in applying hedge accounting to portfolio hedging strategies and that in many cases hedge accounting could not be achieved. This ultimately led to the IASB making amendments to IAS 39 to try to improvement its practical application – these amendments are discussed later on in this paper.

8. The main challenges in applying the first version of IAS 39 to portfolios are summarised below[2]:

1 Numerous other restrictions apply in the IAS 39 hedge accounting requirements which will not be expanded on in this paper.
2 Refer to paragraph BC 176 to BC 218 of the Basis to Conclusions to IAS 39 for further details.

Prepayment risk – impact on effectiveness

9. Typically, many assets in a portfolio may be prepayable (for example, mortgages which include early repayment options). However, a derivative that may be used as a hedge of the portfolio typically is not prepayable. When interest rates change, the change in the fair value of the prepayable hedged assets differs from the change in fair value of the non-prepayable hedging derivative[3]. As a result that the hedge may not meet IAS 39's effectiveness tests for offset of between 80 and 125%[4] and hence hedge accounting could not be applied.

Requirement for hedged items to be 'similar' – impact on ability to designate

10. Prepayment risk may have the effect that the items included in a portfolio hedge fail the requirement (in paragraph 78 of IAS 39) that a group of hedged assets or liabilities must be 'similar' and the related requirement (in paragraph 83 of IAS 39) that 'the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items'.

Hedging net positions – impact on systems

11. IAS 39 paragraph 17 prohibits the designation of an overall net position as the hedged item. Instead it requires individual assets (or liabilities), or groups of similar assets (or similar liabilities), that share the risk exposure equal in amount to the net position to be designated as the hedged item. However, for risk management purposes, entities often seek to hedge the net position. This net position changes each period as items are repriced or derecognised and as new items are originated. Hence, the individual items designated as the hedged item also need to be changed each period. This requires de- and redesignation of the individual items that constitute the hedged item, which gives rise to significant systems needs.

Fair value hedge adjustment - impact on systems

12. Fair value hedge accounting requires the carrying amount of the hedged item to be adjusted for the effect of changes in the hedged risk. This could involve changing the carrying amounts of many

3 IFRS 9 specifically introduces the concept of hedging a 'layer component'. However paragraph B6.3.20 of IFRS 9 prohibits designation of a layer component that includes a prepayment option as a hedged item in a fair value hedge if the prepayment option's fair value is affected by changes in the hedged risk, unless the designated layer includes the effect of the related prepayment option when determining the change in the fair value of the hedged item.

4 The hedge accounting requirements of IFRS 9 no longer require offset in the range 80-125%.

thousands of individual items in a portfolio. Also, for any items subsequently de-designated from being hedged, the revised carrying amount must be amortised over the item's remaining life. This, too, gives rise to significant systems needs.

Financial instruments with a 'demand feature' – impact on ability to designate

13. IAS 39 paragraph 49 specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. As a result applying fair value hedge accounting under IAS 39 is prohibited, beyond the shortest period in which the holder can demand payment (unless those items are within a 'net position' in which the financial instruments with the demand feature are not those specifically designated as the hedged items).

(B) Existing IFRS Accounting Available for Open Portfolios

IAS 39 - Fair value macro hedging amendments

14. In response to the challenges outlined above, the IASB made amendments to IAS 39 in March 2004. Those amendments provided special exceptions in relation to accounting for a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (commonly referred to as 'fair value macro hedging').

15. In particular, for such a hedge, it allowed:

    a) the hedged item to be designated as an amount of a currency (eg an amount of dollars, euro, pounds or rand) rather than as individual assets (or liabilities);

    b) the gain or loss attributable to the hedged item to be presented in a single separate line item (within assets or liabilities as applicable);

    c) prepayment risk to be incorporated by scheduling prepayable items into repricing time periods based on expected, rather than contractual, repricing dates; and

    d) the gain or loss attributable to the hedged item (see b)), was permitted to be amortised to profit or loss using a straight line method (if it were not practical to amortise it using a recalculated effective interest rate) over the relevant repricing time period (rather than by maturity of the financial instrument).

16. Arguably the most significant of the three exceptions is c), to permit expected rather than contractual repricing periods to be considered. The effect of this is exception is that an entity could consider the expected prepayment pattern of prepayable instruments when determining their fair value for the purpose of measuring the effectiveness of a hedging relationship.

17. Typically, risk management activities would be focused on managing the expected repricing dates of prepayable items, rather than contractual repricing dates. This exception was therefore intended to allow accounting to align more closely with risk management activities.

18. As a consequence of applying fair value macro hedge accounting, changes in the expected repricing dates (due to changes in the hedged interest rate) are included when measuring effectiveness. This would mean that when a portfolio of prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

19. Some would argue that as this represents real economic ineffectiveness it is appropriate to recognise this mismatch as ineffectiveness in profit or loss.

20. It therefore follows that, when the expected prepayment pattern of items in the hedging relationship changes, 'good' risk managers would take action to manage the hedging relationship to reduce ineffectiveness. This would be achieved, for example, by adjusting the derivatives position to realign with the revised expected prepayment pattern of the hedged items.

21. To some extent, each of the challenges identified above was addressed by the amendments, except for that relating to demand deposits which cannot be designated in a net position. However, notwithstanding these improvements to IAS 39, many would say that the application of fair value macro hedging under IAS 39 remains onerous and not fully aligned with risk management practices.

IAS 39 – Cash flow macro hedging

22. As an alternative to 'fair value macro hedging' entities could apply cash flow hedge accounting under the 'general' IAS 39 model. However typically that may involve 'proxy' hedge accounting where an instrument is designated against an item which is not directly hedging in accordance with an entity's risk management. This could be attractive if there are items available for designation as hedged items which are not prepayable, and therefore may achieve 'better' effectiveness. However some would criticise this approach as it decouples accounting from risk management activities.

IAS 39 – Fair value option

23. Another alternative would be to apply the 'fair value option' available in IAS 39. However this may be unattractive as it requires a full fair value remeasurement (including fair value from risks other than that being managed by the entity, for example credit risk).

IFRS 9 hedge accounting

24. In December 2013 the IASB issued amendments to IFRS 9 [IFRS 9 *Financial Instruments (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39)*] ('December 2013 amendments'). Those amendments included Chapter 6 *Hedge Accounting* which places greater focus on aligning accounting with risk management activities[5].

25. Entities are permitted to make an accounting policy choice to continue to apply the hedge accounting requirements of IAS 39 to all of its hedging relationships instead of the requirements in IFRS 9 when it first applies IFRS 9 (refer to paragraph 7.2.16 of IFRS 9).

26. Alternatively, an entity may apply the hedge accounting requirements in IAS 39 instead of those in this IFRS 9 for a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only for such a hedge!) (refer to paragraph 6.1.3 of IFRS 9).

27. Despite the significant changes to the hedge accounting requirements introduced by IFRS 9, as for IAS 39, IFRS 9 does not allow cash flow hedges of interest rate risk to be designated on a net position. Consistent with IAS 39 designation must be made of a gross position, notwithstanding how risk management is actually achieved. However, 'proxy hedging' is still an eligible way to designate a hedged item. For example the designation of the hedge may be made on a gross position basis even if risk management is on a net position basis. Proxy hedging is still valid as long as the designation reflects risk management ie. it is related to the same type of risk that is being managed and the financial instruments actually used for that purpose (refer to paragraph BC6.40 of the Basis of Conclusion to IFRS 9).

5 In those amendments, the IASB also withdrew the mandatory effective date for IFRS 9. However the phases for recognition and measurement of financial assets, financial liabilities and hedge accounting are available for early adoption. With some exceptions, all earlier issued phases of IFRS 9 must be applied on first time adoption, for example, to apply the IFRS 9 requirements for hedge accounting, the requirements for recognition and measurement of financial assets and financial liabilities must also be applied.

Practice in Australia

28. Current practice in Australia is somewhat diverse. Australian financial institutions use a variety of accounting approaches and combinations thereof, including;

    - not applying hedge accounting;
    - using the IAS 39 fair value option;
    - IAS 39 fair value hedge of a portfolio of interest rate risk;
    - IAS 39 cash flow hedging, using 'proxy hedging' to designate a gross position where a net position cannot be designated;
    - IAS 39 cash flow hedging, using 'proxy hedging' of hedged items (ie where the hedged item subject to risk management is not eligible for hedge accounting, or hedge accounting would be difficult to achieve, and so an alternative item is designated which is not directly related to the risk management activities of the hedging instrument;
    - using a single derivative in two hedging relationships using a split designation[6].

29. For a number of reasons cash flow hedge accounting is considered by many to be preferable to fair value hedge accounting. For example, it is often easier to achieve 100% effectiveness under IAS 39 than when applying fair value hedge accounting due to the mechanics of 'lesser of test' in paragraph 96 of IAS 39. Some also consider that effectiveness testing is often less onerous for cash flow hedges. This 'arbitrage' between fair value and cash flow hedge accounting continues to exist in IFRS 9.

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6 Split designation refers to notionally imputing 'fixed legs' into 'floating to floating' swaps. For example, consider a swap that pays 1 month LIBOR and receives 3 month LIBOR. Two notional swaps could be defined by taking one of the payment streams of the real swap and adding a fixed leg to each to create two new 'notional swaps' as follows:

Notional Swap 1:	pay 1 month LIBOR / receive fixed
Notional Swap 2:	pay fixed / receive 3 month LIBOR.

The cash flows of the receive fixed leg of Notional Swap 1 would be defined to be equal and offsetting to the pay fixed leg of Notional Swap 2. If the two swaps are 'added together' the fixed legs would therefore eliminate. Hedge accounting may be achieved by designating each of the two notional derivatives in a cash flow hedging relationship.

Accounting for the economics?

30. It could be argued that none of these approaches wholly aligns the accounting with the economics of the underlying transactions and the associated risk management activities. However each approach, is, to an extent, a work-around solution to achieve accounting which more closely reflects the underlying economics than if no hedge accounting is utilised.

31. Some would say that the problem arises from the mixed measurement objectives and recognition criteria contained in the accounting standards. The most common problem to which hedge accounting is applied is accounting for derivatives at fair value through profit or loss (FVPL), when other items are recognised on a different basis, such as cost, amortised cost or not recognised at all.

32. Hedge accounting and fair value option approaches attempt to realign the accounting of these other items with the derivatives, by one of the following methods:

    a) remeasuring the other items through profit or loss for a 'hedged risk' component, (fair value hedge);

    b) remeasuring the derivatives through other comprehensive income (OCI) (cash flow hedge);

    c) remeasuring the derivatives and other items through foreign currency translation reserve (FCTR) (hedge of a net investment in a foreign operation); or

    d) remeasuring the other items through profit or loss for the full change in fair value (fair value option).

33. It could be said that hedge accounting and the fair value option serve as tools to reduce accounting volatility in profit or loss, where 'default accounting' would give rise to 'artificial volatility'. The accounting from these tools achieves one of the following:

    Fair value hedge

    - to bring to account a partial remeasurement of items that would not otherwise be required at that time (eg. remeasuring an item at cost, for changes in its fair value that are due only to changes in interest rate risk). Other changes in fair value of the items are not brought to account at that time.

    Cash flow hedge

    - to relocate remeasurement of derivatives from profit or loss to OCI; and

- to continue to not bring to account the remeasurement of the designated hedged items.

Hedge of a net investment in a foreign operation

- to relocate remeasurement of derivatives from profit or loss to FCTR; and
- to continue to retranslate the hedged foreign net investment through FCTR.

Fair value option

- to bring to account a full remeasurement of items that would not otherwise be required at that time).

34. By way of example, consider an unrecognised firm commitment denominated in a foreign currency which is hedged using a derivative hedging instrument. Under IAS 39, these two items could be designated in either a fair value hedge to partially 'fix' the lack of recognition of the firm commitment, or a cash flow hedge, to defer the derivative gains or losses to OCI. Not hedge accounting at all would certainly not reflect the underlying economics, but neither the cash flow nor fair value hedge accounting mechanisms seem to fully reflect the underlying economics either. The fair value option at least brings both items to account on the same basis, however the fair value option may introduce accounting volatility if the risks in the hedged item are not perfectly hedged by the derivative (eg. changes in the fair value of a bond's credit risk may not be fully offset by changes in the fair value of a derivative whose primary purpose is to hedge foreign currency risk).

35. A further concern with IAS 39 is that the effects described above are limited to the portion or proportion of the items that is specifically designated. For example, if $50 million of a $100 million bond is designated in a fair value hedge, only half the bond would be remeasured for the hedged risk. The other half of the bond would not be remeasured for the hedged risk, despite the fact that the economics of that half of the bond would be identical to the remeasured portion. However this would also be the case if the bond were not in a hedging relationship at all.

36. In each of these cases it could be argued that the problem hedge accounting is seeking to solve is the not the volatility in profit or loss arising from accounting for the derivative at FVPL, but the different bases used in accounting for the recognition and measurement for different items.

(C) Preliminary Comments on the IASB's Forthcoming Discussion Paper (DP)

Objective of the Project

37. As at the date of this Agenda Paper the IASB has not yet issued its DP. The following is therefore based on IASB Board papers. The comments below are not intended to be comprehensive, but to provide some considerations for discussion.

38. The objective of the project is to simplify and improve the usefulness of financial statements by developing accounting requirements for hedging within the context of open portfolios that are more closely aligned with a company's risk management activities. The intention is to reflect how businesses manage risk dynamically, and also help users understand risk management activities through greater transparency about an entity's actual business and risk management activities.

Revaluation approach

39. The approach is not as such a 'hedge accounting' approach (so would not require effectiveness testing), but a 'revaluation approach'. The basis of the approach is as follows:

    a) to continue to measure derivatives at fair value through profit or loss (FVPL);

    b) to identify and remeasure the hedged risk position of non-derivative items for changes in the hedged risk, and recognise the gain or loss on that remeasurement in profit or loss (although the use of OCI will also be contemplated in the DP); and

    c) to provide disclosures regarding the factors and inputs for the remeasurement.

40. In comparison to the existing accounting available in IAS 39 and IFRS 9, the approach seems to be similar to fair value hedge accounting (and cash flow hedge accounting if OCI is utilised). The approach does not attempt to identify a conceptual measurement basis for the non-derivative items but would be a partial remeasurement for a specified risk or risks only. This seems to suggest that the approach is not intended to fully align accounting with the underlying economics, as discussed above, but to bridge the gap between measuring derivatives at FVPL and recognising (or not!) and measuring other items on other bases.

Scope – eligible items

41. A critical question concerns the scope of the approach, in particular, what items would qualify for the approach. Potential items could include:

a) financial assets (eg mortgage assets);

b) financial liabilities (eg. deposits and deposits payable on demand);

c) loan commitments;

d) non-financial assets (such as inventory);

e) non-financial liabilities;

f) 'equity model' book positions (eg. where a bank disaggregates its target return on equity into base return and a residual return above the base return, the target return may be managed in a similar way to interest rate risk);

g) firm commitments;

h) forecast transactions;

i) unrecognised 'pipeline' trades (for example an entity may manage the interest rate risk from the forecast issuance of products at advertised rates;

j) 'internal' derivatives (such as with an Asset Liability Management (ALM) function within a bank);

k) insurance contracts.

42. Hedge accounting is currently prohibited for some of the items (eg many internal derivatives, equity model book positions and deposits payable on demand). A consideration is how far the approach should extend and should it align with risk management practices for such items. The arguments made to date which prohibit allowing hedge accounting for such items would need to be countered.

Scope – extent of application

43. A further consideration is the extent of the application of the model and whether application is optional. For example, should it apply to:

a) discrete portfolios;

b) portions of portfolios (and if so would the portion be defined as a layer, eg. top-down, bottom-up?);

c) proportions of portfolios;

d) an entire entity.

What rules might be created to delineate to what and how the approach may be used?

Scope – eligible risks and the nature of the management of those risks

44. The scope of the project is not intended to be limited to interest rate risk but to discuss an approach which could apply to other risks, for example commodity risk and currency risk. However, the focus of portfolio hedge accounting in IFRS to date has been on interest rate hedging, in particular, where there is a large volume of items in portfolios whose populations change rapidly, and for which risk management is frequent, often on a daily basis therefore, to date, that is the area that has been most discussed.

45. The selection of what the 'managed risk' to be revalued for also needs to be considered and whether application is optional. For example,

    a) should any risk be eligible at the entity's choice (and should this be a one-time election, or could that election be revoked?)

    b) should all 'managed risks' be required to be included in the approach

    c) should it only be applied to open portfolios that are managed 'dynamically'? If so, how would that concept be defined?

Interaction with other IFRS

46. The approach is intended to be an overlay to the classification and measurement requirements in IFRS 9. Consideration would need to be given as to how the approach actually interacts with IFRS 9, including their 'general hedge accounting' requirements. Depending on the scope of the approach the interaction with other IFRS would also need to be considered, for example IAS 21 *The Effects of Changes in Foreign Exchange Rates*; IFRS 4 *Insurance Contracts*; and IAS *Inventories*.

Use of OCI

If OCI were to be utilised in the approach, there would also need to be consideration of whether amounts recognised in OCI are to be recycled to profit or loss, or not. If recycling is to occur, how would the amounts to be recycled and the timing of that recycling be determined? How would the approach align with the thinking being developed through the IASB's Conceptual Framework Discussion Paper? One of the motivations behind developing a new approach is to reduce the operational burden of hedging accounting from designation, effectiveness testing and tracking amortisation. At first sight, it would seem that introducing the use of OCI into a revaluation model

could give rise to a similar operational burden at least for tracking amounts in OCI and for recycling. There is also a question of whether both profit or loss and OCI would be simultaneously available for use. If so, could this lead to the something similar to the current 'patchwork' presentation which arises when entities use of mixture of fair value and cash flow hedge accounting.

Transition and disclosure

Consideration would need to be given to transition from existing accounting approaches to the new approach, and what additional disclosure would be necessary on transition and on an on-going basis.