

Fair Value Hedge Accounting For a Portfolio Hedge of Interest Rate Risk

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Preface

We recognise the progress made by the Board in the treatment of macrohedges and in particular in the possibility of hedging a representative “value” of a net of assets and liabilities as an item without having to identify the single components that form the imbalance. This option does not lessen the impact on organisational processes and information systems but it does resolve the application problems that a strict tracing back to individual operations would have entailed. However, such a tracing back would still be needed if some of the assets forming the imbalance were to be disposed of.

In the same way, we welcome the possibility of including a number of derivatives contracts intended to hedge risk profiles that have changed over time.

While remaining firmly convinced that the correct accounting treatment for hedging operations should be to align the criterion of valuing derivatives with that of the items hedged and not vice versa, we submit below some considerations relating to the two main issues raised in the new partial draft of IAS 39.

Hedge Ineffectiveness

In defining the method for determining the “accounting” effectiveness of a macrohedge, it is necessary to start from the premise that it is a case of adopting a convention and not a “rule” that perfectly mirrors operational reality. Viewed in this light, it is perhaps more important to apply the accounting convention coherently over time rather than strive for the most correct “absolute” rule.

The proposals envisaged by the Board for determining the effectiveness of hedging operations in terms of amount all have their pros and cons (as is also clear from the document’s “Basis for conclusions”). Hence, it is difficult to determine an absolute preference for one solution over another.

That said, among the various proposals put forward, the solution favoured by the Board (Approach D) seems to offer the most linear application. As it is a case of operations of aggregates that are in part “naturally” hedged, and therefore not valued at fair value, and in part hedged through derivatives, and therefore valued at fair value, it is difficult and perhaps arbitrary to attribute a variation in the situation as expected at the inception of the hedge to the naturally hedged component or to that hedged through derivatives.

Indeed, the solutions based on identifying layers of hedged assets or liabilities yield different results in terms of hedge ineffectiveness depending on whether

the entity is in a situation where the “natural hedge” component is small (e.g. 10 out of 100) or large (e.g. 90 out of 100). In such widely differing situations, entities with exactly the same error in their estimated prepayments (e.g. 20%) would have different situations of ineffectiveness under Approaches A and B because of the different amount of derivative-hedged assets or liabilities.

Furthermore, Approaches A, B and C, which recognise ineffectiveness only in the event of an increase in prepayments compared with expectations, can have an impact on asset and liability management. This is because, in order to avoid the risk of highlighting situations of ineffectiveness, entities could be induced to overestimate expected prepayments in order to highlight a smaller share of derivative-hedged assets or liabilities and so a lower risk of ineffectiveness.

Last, recognition of ineffectiveness only in the event of an increase in prepayments leads to accounting that is not coherent where the over-hedge in one time period translates into an under-hedge in another hedged time period.

However, there are also grounds for supporting EFRAG’s view that a situation of under-hedge should not lead to ineffectiveness as the portion of assets or liabilities representative of the original imbalance and hedged is still present in the portfolio, while the portion added represents a new value that could be the subject of a new hedge on a par with the new assets and liabilities arising in the period.

Another Imitation of Approach D concerns the fact that a partial hedge of the imbalance (a frequent occurrence in banking practices) leads to the recognition of situations of ineffectiveness also where prepayments are higher than expected but within the limits of the unhedged imbalance. This appears to be inconsistent.

Moreover, Approach D leads to the recognition of ineffectiveness when, with overall derivative-hedged values being equal, there are shifts in expected flows between time periods with different derivative-hedged percentages.

Bearing these considerations in mind, Approach C could also be acceptable provided that, as IASB rightly comments, it not be applied in an arbitrary fashion. Therefore, our view is that this approach should be used only in the case of a single macrohedge portfolio that comprises all the “originated” assets and non-trading liabilities (excluding the specifically hedged items) subdivided by time period and for each of which the imbalance (which represents the “hedged value”) and the relative hedged portion are identified. Alternatively, where there is a differentiation of macrohedged portfolios, this differentiation must be based on criteria that have been defined and approved ex ante by the competent house organs and officially documented as required under IAS 39 for the recognition of hedging operations.

This approach has the advantage of being more in line with banking practices.

In the light of these considerations and in view of the difficulty of determining the ranking between Approach C and Approach D, one could consider the hypothesis of not obliging entities to use only one of the two methods but rather to specify their method of determining effectiveness according to Approach C or Approach D and to require that this choice be disclosed in the accounts and that it not be modified over time.

Concerning accounting for amounts included under asset or liability items that correspond to the accumulated amounts of the variations in the fair value of the hedged elements, the derecognition of these amounts should occur “naturally” over time: on the one hand, the current value of the asset or liability will approach the contract value at expiration, while on the other, the amount entered under such items will tend towards zero.

Core deposits

Core deposits constitute a stable, significant and structural component of Italian banks' onerous liabilities. They are being increasingly integrated into ALM strategies for the purposes of risk management and hedging operations.

To a large extent, the portfolio of core deposits is structural. In essence, if it is true that every individual deposit is without a set and determinable duration, it is also true that the portfolio as a whole constitutes a rather broad layer that represents a source of deposits and hence a liability that is sufficiently stable over time.

In this light, this stable component of liabilities must be treated in the same way as the other financial liabilities and assets of the banking book, both in terms of determining the assets and liabilities to be hedged through macrohedges, and for the purposes of designating a fair value hedged liability in the case of a “liability net position”.

The Board maintains that such items cannot be designated as “fair value hedged items”:

1. because valuing core deposits at fair value would mean entering capital gains in the accounts from the moment of the inception of the hedge, as such deposits generally carry nominal rates that are lower than market rates and
2. because their fair value cannot be different from the nominal value.

Concerning initial recognition of capital gains, the problem resolves itself through the management of the change in fair value rather than in absolute terms. Only the change in fair value between the inception of the hedge and the subsequent measurement needs to be determined. This is in line with the principle laid down in paragraph 153 subsection (b) of IAS 39, under which differences in the fair value of hedged items must be accounted for in the profit and loss account only to the extent to which they are attributable to the hedged

risk and only from the time when the hedging operation starts, therefore without considering previous changes in fair value, which reflect an unhedged risk.

Concerning the accounting, the deposit would remain entered at the nominal value and the above change in fair value would be accounted for in a separate balance sheet item.

Concerning the value of a core deposit, if it is true that for the individual depositor this coincides with the nominal value, then in the event of a transaction with a third party, where market rates differ from those contracted, the price would certainly be different from the nominal value of the deposit.

In the same way, within the scope of valuing an entity, the valorization of a hedged portfolio of deposits is certainly different from that attributed to an identical unhedged portfolio (naturally, always in a situation where market rates differ from nominal rates).

Other comments

Concerning the determining of hedge effectiveness, the link between the provisions in the previous draft of IAS 39 (hedge ratio 80-125%) and the proposals in the new draft is not clear. The option to determine the hedged "value" in terms of expected rather than contracted cash flows increases the likelihood (because of the prepayments variable) of a partial ineffectiveness of hedging operations. Under the new provisions envisaged by the Board, this ineffectiveness must be calculated proportionately in percentage terms.

As the new provisions are to be in addition to the existing paragraphs of ED 39, it appears that the range provision remains in force. If so, then where the percentages are outside the 80-125% range, the whole operation should be considered ineffective and hedge accounting should be suspended.

However, our view is that the logic for determining the ineffectiveness for macrohedges should not co-exist with the above-mentioned range; the range should apply only to cases of specific hedges.

Where ineffectiveness arises in terms of the above threshold values in an aggregate hedge, the dynamic management of hedges enables new hedging operations to be implemented so as to make the hedge effective again for the future. In this situation, the suspending of "hedge accounting" is not appropriate.