European Banking Federation

IASB MEETING, DECEMBER 2006
AGENDA PAPER 9A

Interest Margin Hedge

London
December 13th 2006

European Banking Federation

Agenda

- IMH in a Nutshell
- Importance of a Portfolio View
- Filling the Gap
- Protecting the Gap – Two Scenarios
- Same Risk & Fair Value Change
- Designation
- Ineffectiveness
- Tracking of Ineffectiveness
- Core Deposits
- Summary

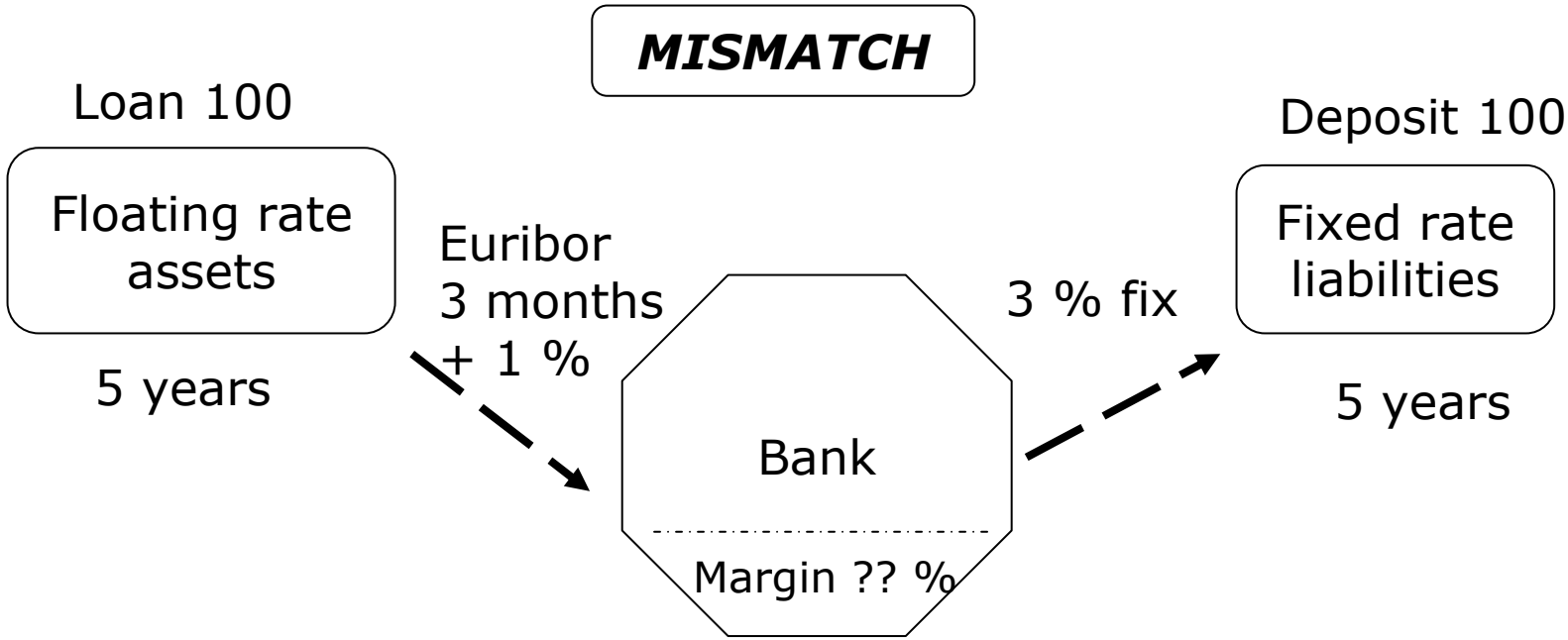
European Banking Federation

IMH in a Nutshell

- Alignment of hedge accounting with
  - state of the art interest risk management, and
  - consideration of Core Deposits as an integral part
- Hedging of the interest margin
  ➔ Interaction of interest income and expense generates interest rate risk, not single assets or liabilities
- Based on net positions per maturity gaps
- The hedged risk: the benchmark component of the contractual interest rate, *securing today's interest rate levels*
- Fair Values of effective hedging derivatives remain in equity

Importance of the Portfolio View

- Where does variability come from?
  - When does variability create risk?
  - Can risk derive from a fixed rate item?
- Only the Portfolio View provides the answer:



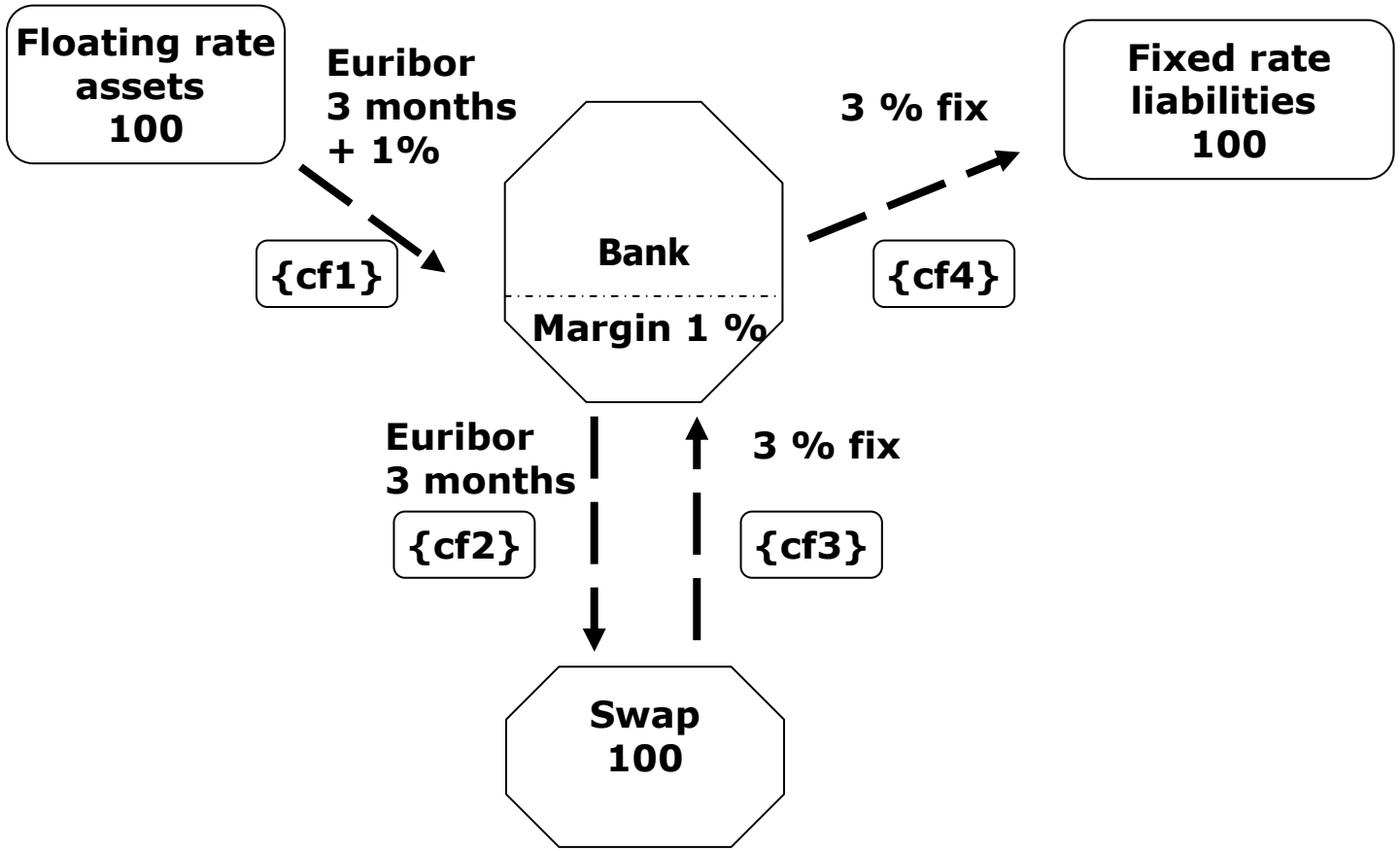
European Banking Federation

Determination of a gap

- Mismatch of assets/liabilities
  in a specified time period: a gap
  - Aggregate fixed-rate assets and liabilities of the same (or similar) repricing dates
  - Leads to excess of one side within the same time periods
- A gap indicates the hedged items to be designated:
  - Currently existing funding or investment in floating rate items, or
  - the respective future transactions for funding or investment

Filling a Current Gap

- Objective: fix the level of interest rate at inception of the hedge



European Banking Federation

A Future Gap

- Example (liability sensitive): gap in years 3 - 5
  - Objective: fix the level of interest rate at inception of the hedge

		notional	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**
Assets	5Y	100	100	100	0	0	0
Liabilities	5Y	-100	-100	-100	-100	-100	-100
	Net-Position	0	0	0	**-100**	**-100**	**-100**
Forward Swap rec fix pay float	**3Y/3m**				**100**	**100**	**100**

European Banking Federation

Filling a Future Gap

- Conditions of future transactions are unknown
  - Fixed or Float?
  - Level of interest rate?
- Customer demands determine the future conditions
- The risk: future interest rates are uncertain
- Protection: fix interest rates today for either fixed or float future transaction
- Currently, IAS 39 doesn't permit this IMH

European Banking Federation

Protecting a Future Gap

- Same risk – same instrument
  - Designated risk: Libor component of forward rates
  - Non arbitrage characteristics of the forward rates embedded in the yield curve
- Scenario 1: future floating-rate transaction
  - Instrument: Forward Swap
- Scenario 2: future fixed-rate transaction
  - Instrument: Forward Swap

Same Risk & Fair Value Change

- Appropriate accounting treatment of fair value change (starting year 3) of the derivatives achieves hedge objective

European Banking Federation

Designation

- The bank identifies a portfolio of fixed rate financial instruments, i.e. assets and liabilities
- Aggregating them by their repricing dates into predefined time buckets
- Thus identifying a net open position of a specified gap
- Identifies by notional amounts existing variable rate items that currently fill the gap and/or future transactions that will fill the gap

European Banking Federation

Designation

- Designates them for their interest cash flows to be the hedged items
- Designates a part of the contractual interest rate that corresponds to a benchmark interest rate as the risk which it is hedging
- Designates one or more hedging instruments for each specified period of mismatch

European Banking Federation

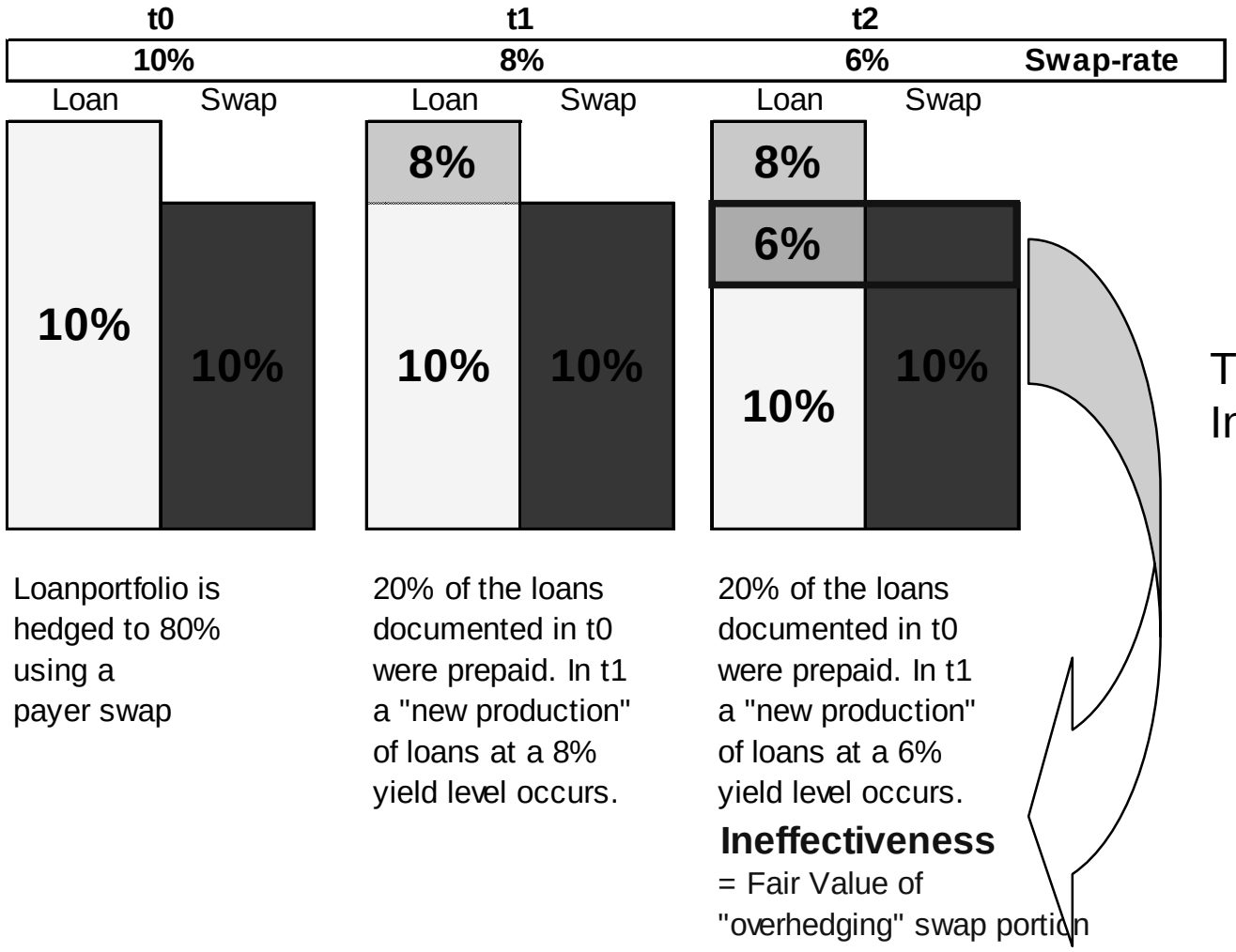
Effectiveness Testing

- Testing for
  - Close proximity of cash flow dates
  - “Overhedging” by
    - notional amount
    - maturity
- Testing twice
  - before including new production and new hedges in the hedge portfolio
  - after taking into account new production

Testing against Hedge Objective

- Primary objective: Identification of ineffective Derivatives (or portions thereof)
- Prevention of any management discretion (in case of multiple hedging derivatives per gap)
- Hidden ineffectiveness requires tracking of
  - Gaps as initially analysed
  - Derivatives designated
- Potential Solution → Hedge Matrix

Tracking Ineffectiveness



Loanportfolio is hedged to 80% using a payer swap

20% of the loans documented in t0 were prepaid. In t1 a "new production" of loans at a 8% yield level occurs.

20% of the loans documented in t0 were prepaid. In t1 a "new production" of loans at a 6% yield level occurs.

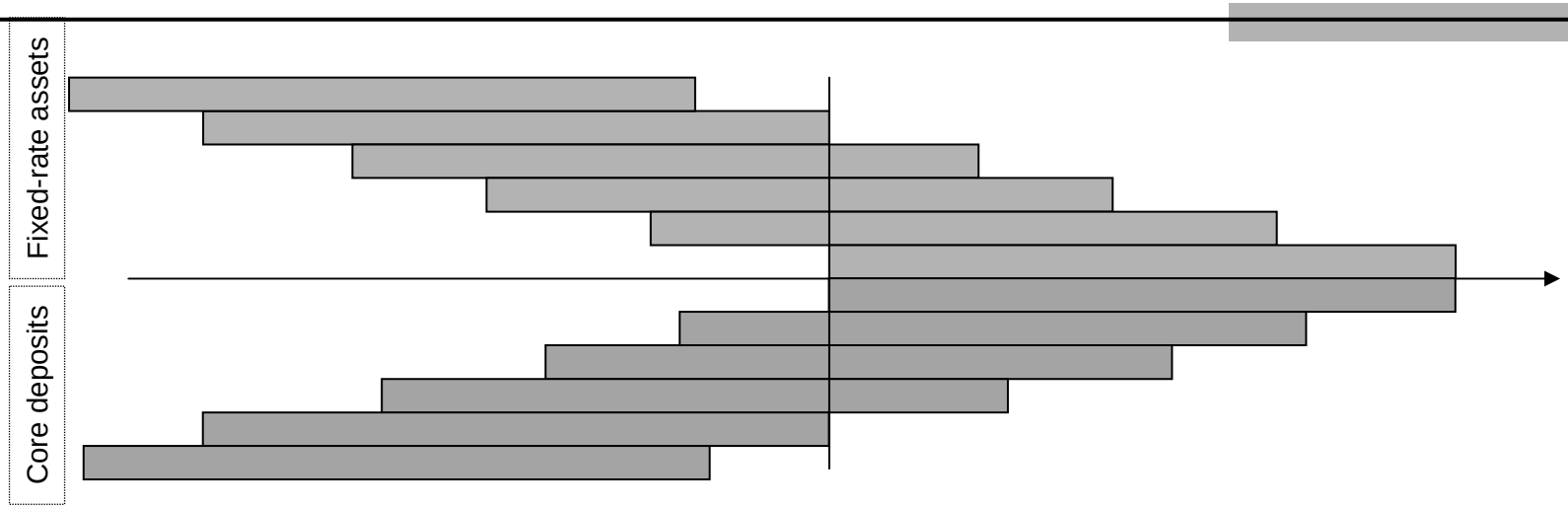
Ineffectiveness
= Fair Value of "overhedging" swap portion

European Banking Federation

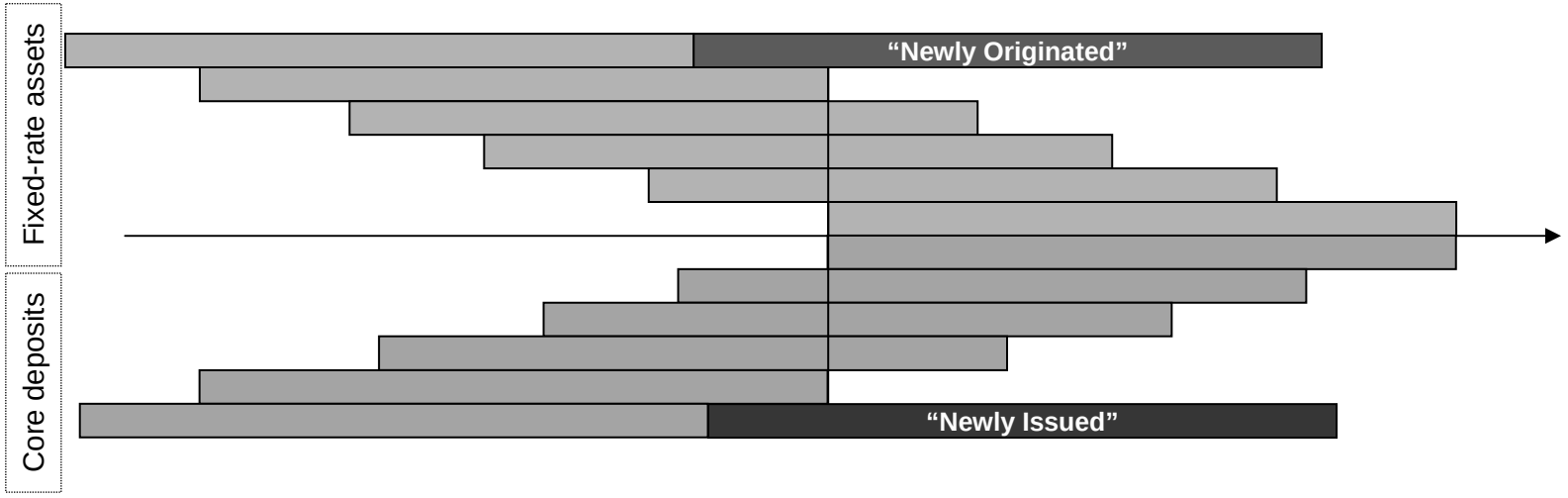
Core Deposits

- Core Deposits represent “fixed-rate” liabilities
  - offsetting naturally fixed-rate assets or
  - generating the need for fixing the interest rate level for their corresponding investment
- Core deposits are incorporated in the IMH portfolio based on behavioural assumptions, using state of the art risk management practice:
  - core volume approach, replicating portfolio, diffusion process etc

Core Deposits & New Production



Core deposits, assumed to have matured in the last period,
are assumed to offset the origination of new assets of the next period.



European Banking Federation

Summary

- IMH aligns state of the art interest risk management and accounting
- IMH integrates core deposits in the hedging portfolio
- Despite strong similarities, IMH can currently not be designated as a CFH
- Most ALM systems used by the industry could be utilized as a basis for implementing the IMH approach