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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: 13 December 2006, London

Project: Financial Instruments

Subject: Interest Margin Hedging (Agenda Paper 9C)

OVERVIEW OF PAPER

1. This paper sets out the background to the proposals for an alternative hedge accounting model received from the European Banking Federation (FBE).
2. This paper also discusses a number of key issues and concerns identified by the IASB staff and certain board members (the 'IASB team') relating to the proposed model.
3. It is not the purpose of this paper to describe in any detail the proposed alternative hedge accounting model; representatives from the FBE have been asked to present and discuss the proposed model at an education session during the December board meeting.¹
4. [Paragraph omitted from observer notes]

¹ This paper is based on our understanding of previous papers received from, and discussions previously held with, the FBE. This paper does not consider any changes that the FBE may have made to their proposed model that are included in their materials submitted for the December IASB Education Session.

BACKGROUND TO THE IMH PROPOSALS

5. The European Commission adopted IAS 39 *Financial Instruments: Recognition and Measurement* in November 2004 with the exception of certain provisions relating to the full fair value option and hedge accounting (the ‘carve-outs’). The fair value option carve-out was subsequently removed, following the amendment to IAS 39 *The Fair Value Option* which was issued in June 2005.
6. The second carve-out of certain hedge accounting requirements reflected criticism by some European banks that IAS 39 would force them into “disproportionate and costly changes both to their asset/liability management and to their accounting systems and would produce unwarranted volatility”.

Discussions with the FBE

7. The IASB team has held five meetings with representatives of the FBE since March 2004.
8. These meetings have been held to discuss an alternative to the existing hedge accounting models in IAS 39. The proposed alternative model – termed the Interest Margin Hedging (IMH) model – has been developed by the FBE to address the issues relating to existing asset/liability management practice and the ‘unwarranted’ volatility created by the current requirements of IAS 39 that were highlighted by the EC in its decision to carve-out certain hedge accounting requirements of IAS 39.
9. In the discussions with the FBE, the IASB team has repeatedly asked a number of key questions. This paper summarises those key questions. The IASB team does not believe that satisfactory answers have been received to those questions.

10. However, before proceeding to a summary of those key questions and issues, in order to better enable board members to judge the merits of the FBE proposals the staff believe it worthwhile to:

- a. set out the guidelines given to other constituents wishing to propose amendments to the hedge accounting requirements of IAS 39,
- b. set out the principles underlying IAS 39 and hedge accounting, and
- c. provide some relevant background from the March 2004 amendment to IAS 39 *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* (Macro hedging).

Guidelines given to other constituents wishing to propose amendments to the hedge accounting requirements of IAS 39

11. The staff has provided informal guidelines to constituents who have looked to propose possible amendments to the current hedge accounting requirements of IAS 39. (These guidelines are in addition to a requirement of consistency with the underlying principles of IAS 39 that are outlined in the next section.)

12. The staff has suggested to constituents that any possible amendment would need to both:

- a. result in an improvement and simplification of IAS 39, and
- b. be consistent with the Board's stated long-term objective of measuring all financial instruments at fair value

The principles underlying IAS 39 and hedge accounting

13. IAS 39 is based on a number of principles that govern the accounting for derivatives and the application of hedge accounting. These principles were outlined in the March 2003 round-table hearings on IAS 32 *Financial Instruments: Presentation* and IAS 39, and are similar to those underlying the relevant US literature. This section outlines those principles

14. *Principle 1* - derivative contracts create rights and obligations that meet the definitions of assets and liabilities and, as a result, should be recognized.
15. *Principle 2* - fair value is the only relevant measurement basis for derivatives because, for example, it is the only measurement basis that can communicate to the users of financial statements the nature of the rights and obligations inherent in derivatives (such as the level of risk arising from the leveraged nature of a derivative).
16. *Principle 3* – items that do not meet the definition of assets and liabilities (such as deferred gains and losses) should not be recognised as if they were assets and liabilities².
17. *Principle 4* – hedge accounting is a departure from normal accounting treatment that would otherwise be applied to the items in the hedge accounting relationship.
18. *Principle 5* – because hedge accounting is a departure from normal accounting treatment, hedge accounting principles are required to provide discipline over the use of hedge accounting. Such principles prevent a free choice over when to recognize gains and losses.
19. *Principle 6* – the criteria to be met to qualify for hedge accounting include that:
- a. there must be exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, or exposure to variability in cash flows that is attributable to a particular risk associated with a recognized asset or liability or a highly probable forecast transaction, that could affect profit or loss,³
 - b. a hedging relationship must be designated and documented at the inception of the hedge as well as the entity’s risk management objective and strategy for undertaking the hedge, and

² So for special cash flow hedge accounting, qualifying gains and losses on the hedging instrument are reported as a component of equity until the offsetting gain or loss is recognized in profit or loss.

³ Including identified portions for certain exposures.

- c. the effectiveness of a hedging relationship must be reliably measurable and is expected to be, and actually was, highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistent with the originally documented risk management strategy for that particular hedging relationship.

20. *Principle 7* – if a hedging relationship is not effective, the ineffectiveness is recognised immediately in profit or loss.

Macro hedging amendment

21. Following the IAS 32 and IAS 39 roundtables, the IASB worked with the FBE (at the request of European banks) and developed a macro fair value hedging approach. This approach applies the hedging principles underlying IAS 39 to portfolios of assets or liabilities.
22. The resulting amendment was limited to applying fair value hedge accounting to a hedge of interest rate risk on a portfolio of items. The implementation guidance on IAS 39 (IG F6.1, F6.2 and F6.3) already explained how to apply cash flow hedge accounting to a hedge of the interest rate risk on a portfolio of items.
23. The staff believe that the following decisions taken (and issues discussed) by the Board as part of the macro hedging amendment are relevant to the IMH discussion:
 - a. *Hedging a net position* – (consistent with the existing requirements of IAS 39) the Board decided that an overall net position may not be designated as the hedged position. (Also see comments in paragraph 26).
 - b. *Demandable liabilities*⁴ – in the Basis for Conclusions the Board confirmed (i) the requirement in IAS 39 that “the fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid” and, consequently (ii) that demandable

⁴ That is, liabilities repayable on demand or after a notice period.

liabilities should not qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment. (Non-interest bearing demand deposits are also precluded from being designated as a hedged item in cash flow hedging of interest rate risk on a portfolio of items, as set out in IGF6.1 to F6.3).

- c. *Tracking of the amount in a repricing period and systems requirements* – the Board decided that ineffectiveness should be calculated by determining the change in the estimated amount in a repricing period between one date on which ineffectiveness is measured and the next. Thus under the amendment there is no requirement to track an amount in a repricing period for multiple periods, hence reducing the potential systems complexity.
- d. *Ineffectiveness arising from changes in prepayment expectations* – under the amendment 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 expected⁵.
- e. *The carrying amount of the hedged item and systems requirements* – the amendment permitted the hedged item to be designated as an amount of currency (rather than individual assets and liabilities) and hence required no adjustment to the carrying values of individual items⁶. This reduced the potential systems complexity.
- f. *Derecognition of amounts included within the separate line items*⁷ – to ensure that gains and losses included within the separate line items are recognized in profit or loss in the appropriate time periods, and recognizing the systems implications of requiring the scheduling and tracking of individual assets or liabilities, the amendment included

⁵ Assuming that a portfolio that contains prepayable items is hedged with a non-prepayable derivative.

⁶ Instead of which, gains and losses attributable to the hedged item are presented as a single separate line item within either assets (for those repricing time periods for which the hedged item is an asset) or liabilities (for those repricing time periods for which the hedged item is a liability).

⁷ See previous footnote.

detailed safeguards to ensure that amounts included in the separate balance sheet line items are removed from the balance sheet over a reasonable period and do not remain in the balance sheet indefinitely.

KEY ISSUES IDENTIFIED RELATING TO THE PROPOSED MODEL

24. During the discussions with the FBE the IASB team identified a number of key questions about the proposed model. The IASB team does not believe that we have received satisfactory answers to those questions. The following section describes those key questions and provides an analysis of the responses received from the FBE.

What is the risk being hedged?

25. The IMH model purports to hedge possible variability in the future interest margin (the amount of reported accruals based interest income less the amount of reported interest expense) associated with a portfolio of recognized fixed rate assets and fixed rate liabilities. For example, by comparing the principal amount and maturity period of a selected portfolio, in a certain time period an entity may have CU100 of fixed rate assets and CU80 of fixed rate liabilities. The entity may believe that the asset/liability 'gap' of CU20 exposes it to interest rate risk and enters into a pay-fixed interest rate swap with a notional amount of CU20 to offset the risk.

26. *Concerns raised by the IASB team* - the questions raised by the IASB team relate to the identification of the item(s) and risk(s) being hedged. First of all, IAS 39 does not permit net amounts to qualify as a hedged item because of the inability to associate hedging gains and losses with a specific item being hedged and, correspondingly, to determine objectively the period in which such gains and losses should be recognized in profit or loss.⁸ This was reconfirmed by the Board in the macro hedging amendment. In addition, hedging variability in a net interest

⁸ Although IAS 39 does permit a designated hedged item to be part of a gross position related to assets, liabilities, forecast cash inflows or forecast cash outflows giving rise to a net exposure.

- margin is hedging an accounting number that, in itself, does not identify an underlying economic fair value or cash flow exposure.
27. IAS 39 requires that an actual fair value or cash flow exposure exists (or be highly probable of occurring) that could affect profit or loss. In the example in the previous paragraph, the entity could be viewed as having converted CU20 of the existing fixed interest rate asset into a floating interest rate exposure. That is, a fair value hedge. However this in itself would not satisfy the stated objective of the IMH model – to reduce the variability of the future net interest margin. In fact, the variability of the net interest margin could increase when the effect of the derivative is taken into account.
28. To conclude that variability in the interest margin is going to be reduced, the assumption would have to be that the pay-fixed interest rate swap is hedging a future forecast transaction – such as the instrument that is going to fill the asset/liability gap. (This would be a cash flow hedge.)
29. The instruments that could fill the asset/liability gap might include new variable-rate liabilities or a new interest-bearing liability that will pay interest at the then-current rate. However, the most likely replacement for the maturing liability may be a non-interest bearing demand deposit. Such a liability has neither fair value nor cash flow risk⁹.
30. Furthermore, IAS 39 does not permit hedge accounting for assumed exposures; they have to be existing exposures or be highly probable of occurring. The IMH model appears to simply assume that a cash flow risk exists whenever there is an asset or liability gap – even though (for example) an existing fixed rate asset may be funded by equity and hence there is no cash flow risk, or the most likely replacement for a liability is a non-interest bearing demand deposit that also has no cash flow risk.

⁹ A non-interest bearing customer deposit due on demand does not expose an entity to an exposure that qualifies for hedge accounting under our existing accounting model (the deposit is carried in the accounts at the amount the depositor can demand back). No change in interest rates can alter the fair value of such an account (and hence there is no ability to use fair value hedge accounting). Likewise, no change in interest rates can alter the cash flows (as there are none) from a non-interest bearing account (and hence there is no ability to use cash flow hedge accounting).

31. Even ignoring the possibility that fixed rate financial assets may be funded by equity (or fixed rate financial liabilities may be funding non-financial assets), the proposed model also permits an entity to choose *which* assets and liabilities to include in a portfolio to which the model would then be applied. Hence, it would be possible for a bank to ‘create’ an exposure and obtain hedge accounting, even though there might be no actual (highly probable or otherwise) variable rate exposure overall. Therefore the volatility of the overall future net interest margin might potentially increase – not decrease (as is the stated objective of the proposed model).
32. *Response from the FBE* – in their proposal, the FBE state that banks do not make any distinction between fair value and cash flow exposures. Rather they hedge the accounting number (net interest margin). The risk being hedged arise from gaps identified from existing positions and do not relate to future transactions. By using a pay-fixed interest rate swap, those interest rate risks are being translated from fixed to variable, and hence there is no requirement (even under the IAS 39 model today) to identify any other transactions as the hedged item.
33. Furthermore, the FBE have rejected any notion that the existing cash flow hedge accounting model might be used because of (1) the ‘gap’ risk management practices used by many banks to hedge interest rate risk and (2) the important role that scheduled core deposits play in determining those ‘gaps’. Such deposits are often viewed as an issue of fixed rate instruments (with a maturity that is based on a ‘prudent’ view of the expected maturity of the demand deposits).
34. *Analysis of response* – if the model is seeking to hedge exposures arising from existing fixed rate assets and liabilities then this is a fair value hedge. We agree, therefore, that there is no requirement to identify any other transactions as the hedged item. However, designating such items fails to reduce the variability in the net interest margin – the stated objective of the proposed approach. Furthermore, the macro hedging amendment already permits such exposures to be hedged (although that model requires ineffectiveness to be recognized if actual prepayment dates of assets differ from those originally expected or expectations

of future prepayments of assets change, and the assets are hedged with a non-prepayable derivative).

35. The only way in which variability in the future net interest margin can be reduced in the example set out above is for there to be a future transaction that creates an offsetting cash flow exposure to interest rate changes. However, we believe that such an offsetting cash flow exposure has to be demonstrated as existing or highly probable of occurring, and not simply be assumed – otherwise there is no way in which a judgment can be made regarding whether (a) the stated objective of reducing variability in the net interest margin is being achieved and, conversely (b) whether an entity is using derivatives as part of a speculative strategy.

How is ineffectiveness identified and measured?

36. Any hedge accounting model must both (a) assess the expectation of effectiveness, and (b) recognize and measure actual ineffectiveness. These are key existing principles in IAS 39.
37. The IMH model includes a complex tracking system (for example, that entails tracking of the initial items in the portfolio and associated outstanding and closed derivative positions throughout multiple periods to test for possible over-hedging) that raises many similar issues to those faced by the Board in the macro hedging amendment.
38. However, despite this tracking system the proposed model actually assumes both that the hedge will be effective, and actually is effective, in reducing the variability of net interest income as long as the principal amount of the asset/liability gap exceeds the notional amount of the derivative hedging instruments.
39. *Concerns raised by the IASB team* - the proposed method of tracking would override existing requirement to measure both prospective and actual effectiveness, because the model does not actually measure whether a reduction in the variability of the accrual-based net interest margin occurs as a result of the

- hedging activity. This also relates to the previous comments regarding risk identification; if the risk being hedged is not identified in the first place, then how can it be measured?
40. Under the proposed model, only over hedging would result in ineffectiveness (that is, the notional amount of the derivative is greater than the ‘gap’ being hedged, or the derivative has a maturity longer than the ‘gap’). Under hedging would not result in ineffectiveness.
41. *Response from the FBE* – the FBE state that an IMH is effective “when it can be demonstrated that the offsetting cash flows of the derivative have reduced the variability of the net interest”. The IMH model tests for effectiveness by tracking (a) the ‘gaps’ of the portfolio as initially analysed and (b) the derivative(s) chosen to hedge this ‘gap’.
42. Under the IMH model, ineffectiveness can only result if the hedging instrument (swap) would have either a notional amount larger than the gap or a maturity longer than the gap. Such over hedging may result from realized prepayments or the rescheduling of either prepayable assets or core deposits.
43. Under the proposed model, under hedging would not lead to any ineffectiveness because hedging with less than the full amount of the ‘gap’ would reduce variability of the interest margin.
44. *Analysis of response* – the only components being used in the effectiveness tests of the proposed model are the ‘gap’ of excess assets or liabilities and the notional amount of hedging instruments. Changes in fair value of the derivative instrument are not evaluated for the purposes of measuring and recognizing effectiveness (the FBE state that “the change in fair value of a hedging instrument is only relevant when it proves to be ineffective”).
45. The assumption (as discussed previously) is that the hedging instrument is reducing variability in the assumed exposures created by future instruments that

are used to fill the ‘gap’¹⁰ and as long as the notional amount of the hedging instrument does not exceed the excess amount of net assets or liabilities being designated, no actual measurement of ineffectiveness is required. In summary, the variability in the interest margin is assumed to be reduced without actually measuring it.

How is the stated objective of the model being met with regard to the treatment of non-interest bearing customer deposits due on demand?

46. As previously discussed, IAS 39 is clear with regard to the accounting for, and measurement of, non-interest bearing customer deposits due on demand (‘core deposits’) as well as the role of such deposits in the hedge accounting models of IAS 39.

47. *Concerns raised by the IASB team* – the IMH model assumes that maturing demand deposits being used to fund fixed rate assets are replaced with instruments that create an exposure to interest rates. The model fails to consider the possibility of replacing core deposits with other core deposits. As such, it is impossible to assess whether the stated objective of reducing variability in the future net interest margin is met.

48. If a ‘gap’ of excess fixed rate assets created by the maturing of core deposits is filled by new core deposits there is no variability in the accrual based interest margin, even if interest rates change. This is because (a) the assets are fixed rate (and hence not affected by a change in interest rates, and (b) the core deposits (both maturing and replacement) pay zero interest.

49. However, under the proposed model, a bank could hedge that ‘exposure’. By doing that the bank actually increases the variability of future net interest margin, taking into account the effect of the derivative. The only way that the variability of the net interest margin would not increase is if the instrument filling the gap

¹⁰ Or, in the words of the FBE, “...fixing the margin by securing the interest rate level at the time of inception of the hedge for future transactions that will fill the gap”.

was an interest bearing liability. This is the same point as made previously in paragraph 29.

50. *Response from the FBE* – the FBE states that (a) core deposits are not the hedged item in the proposed model as they are considered to be fixed rate items (and will therefore not be exposed to changes in interest rates), and (b) they therefore contribute to the fixed rate gaps – which are the basis for future interest margin variability when not matched by fixed rate assets.
51. *Analysis of response* – once again, the issue is fundamentally one of identifying the hedged item and risk, in order to be able to demonstrate expected effectiveness as well as measure and recognize any ineffectiveness. Without this, it is not possible to assess whether the stated objective of reducing variability in net interest income is achieved (regardless of all the other associated considerations regarding the accounting for, and measurement of, core deposits).

SUMMARY

52. This paper has only attempted to outline the key questions and issues with the proposed model that have been identified by the IASB team.
53. As previously discussed, the IASB team has repeatedly asked for answers to these key questions. The IASB team does not believe that satisfactory answers have so far been received to those questions.
54. In addition the staff believes that, regardless of the merits or otherwise of the proposed model, consideration of the proposed model would also necessitate detailed consideration by the Board of many other areas of IAS 39 to ensure a consistent approach throughout IAS 39.
55. These areas would include:
- a. The measurement of core deposits and the treatment of core deposits in the existing hedge accounting models.

- b. The requirement in IAS 39 to identify exposures arising from existing assets and liabilities or highly probable transactions and the ability to designate net positions as a hedged item
- c. The current effectiveness requirements – relating both to the requirement to test the expectation of effectiveness as well as the recognition and measurement of actual ineffectiveness (for example, to test the actual degree of offsetting between the hedged item and hedging instrument).
- d. The componentisation of hedging instruments (such as a swap into a series of ‘swaplets’), the current requirement that a hedging instrument should be considered in its entirety¹¹ and the qualifying effectiveness requirements (the 80/125 tests).

¹¹ With the exception of options and forward contracts – see paragraph 74 of IAS 39.