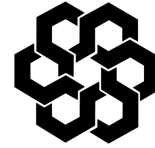

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

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: **17 October 2007, London**

Project: **Financial Instruments**

Subject: **Application of portfolio cash flow hedge accounting to interest rate exposures (Agenda paper 9)**

PURPOSE OF THIS PAPER

1. This paper summarises the discussions between an IASB team (consisting of some Board members and staff) and a number of banks. The purpose of the discussions was to identify any issues arising from application of the portfolio cash flow hedge accounting model in IAS 39 *Financial Instruments: Recognition and Measurement,* and to establish whether clarifications to IAS 39 are necessary.

2. These discussions were held in July and September 2007 and included banks that have operations in a large number of geographical markets. The auditors of the banks also participated in each discussion.

BACKGROUND

3. As a result of the hedge accounting 'carve-out' of IAS 39 by the European Commission, the IASB team has held many meetings with representatives of the European Banking Federation (FBE). In addition, FBE representatives

held a public education session at the December 2006 Board meeting. The extract from IASB Update is as follows:

> Representatives of the European Banking Federation (FBE) presented a summary of their proposal for an interest margin hedge accounting model. One of the reasons for the proposal was a view that some provisions of IFRSs prevent some banks from applying the existing hedge accounting models in IAS 39 *Financial Instruments: Recognition and Measurement.*
>
> Board members asked why a new hedge accounting model was needed. Those Board members suggested that the IFRS provisions that some banks believe prevent them from qualifying for hedge accounting are not, in fact, impediments. The FBE representatives acknowledged that if such clarifications were made, perhaps the existing cash flow hedge accounting model in IAS 39 could be applied. Board members observed that the interest margin hedge accounting model proposed by the FBE would then be unnecessary.
>
> The FBE representatives agreed with a number of points made by Board members, including that:
>
> - any deferral of gains or losses on hedging instruments must be reported in equity.
> - under any hedge accounting model only a gross amount of assets, liabilities, or forecasted transactions should be designated as the hedged item—although the gross designated amount could be arrived at by a risk-management analysis of net exposures in each time period.
> - assets, liabilities, or forecast transactions that have no interest rate exposure cannot be designated as hedged items for any exposure to interest rates. Hence zero rate liabilities cannot be designated as a hedged item. Therefore, measurement of core deposits is irrelevant, except as needed in the risk-management analysis of net exposures.
> - Ineffectiveness must be measured and recognized in profit or loss in any hedge accounting model.
>
> One Board member also observed that the interest-margin hedging approach might be considerably more complex than a proper application of the cash flow hedge accounting model in IAS 39.
>
> On the basis of the discussion and the points of apparent agreement, some Board members and FBE representatives suggested that another approach would be more constructive and consistent with both parties' objectives. Representatives of the FBE agreed to prepare a list of specific paragraphs that are perceived by some to prevent the use of cash flow hedge accounting. The IASB will then analyse the paragraphs determining whether any clarifications are necessary and appropriate.

4. There have been several formal and informal discussions with the FBE since the December 2006 education session. These discussions were summarised in the June 2007 IASB Update. The relevant extract is as follows:

> At a public education session held in December 2006 representatives of the European Banking Federation (FBE) presented to the Board a summary of the FBE's proposal for an interest margin hedge accounting model. At that session the Board questioned whether a new hedge accounting model was necessary if some clarifications were made to the cash flow hedge accounting model in IAS 39 *Financial Instruments: Recognition and Measurement*. The representatives of the FBE agreed that clarifying IAS 39 would be more constructive and consistent with both parties' objectives. The representatives of the FBE identified some issues and agreed to prepare a list of specific paragraphs that, in their view, would require clarification.
>
> In June 2007 some IASB members and staff and representatives of the FBE met and discussed the suggested clarifications.
>
> In an update for the Board, it was noted that the possible clarifications to IAS 39 that had been raised at the December 2006 meeting were also discussed at the meeting in June. It was also noted that that some Board members and staff intend to hold discussions with some banks that currently use the cash flow hedge accounting model set out in IAS 39. The purpose of these discussions will be to understand the application issues faced by those banks and to help establish whether clarifications to IAS 39 are necessary.

5. For background information, some Board members may wish to read the appendix. The appendix discusses interest rate risk in the context of asset and liability management in a bank, and how the IAS 39 hedge accounting models can be applied in that context. The appendix is an extract from a December 2006 Board paper. [Appendix omitted from observer note].

SUMMARY OF DISCUSSIONS WITH BANKS

6. The overall findings are that:

    a. Existing hedge accounting requirements are complex. This complexity is compounded when applying hedge accounting to a portfolio of items.

    b. All of the banks have invested considerable time and resources in developing systems to qualify for hedge accounting. In addition, the application of hedge accounting requires significant resources on an ongoing basis.

    c. As a result of the investment, all of the banks clearly understand the requirements of IAS 39 (in respect of portfolio cash flow hedge accounting) and are able to apply cash flow hedge accounting to portfolios of items with interest rate exposures. No application issues were identified that have proved insurmountable. However, some banks suggested some clarifications to existing requirements (these are discussed in greater detail below).

    d. The banks use existing asset liability management (ALM) systems as the basis for applying portfolio cash flow hedge accounting. Some commented that the hedge accounting approach set out in F.6.3[1] of the Implementation Guidance on IAS 39 is closely aligned to the bank's ALM process. It was also clear that the ALM drives hedging decisions, not the hedge accounting requirements. However, hedge accounting requirements influence *how* particular hedging transactions are executed in specific situations.

    e. Cash flow hedge accounting requirements do not fully reflect the ALM process. That is, IAS 39 is restrictive because it does not necessarily allow the banks to designate certain exposures that a risk manager may economically hedge. It is therefore not surprising that many banks

---

[1] IG F.6.3 illustrates the application of cash flow hedge accounting to portfolios of items with interest rate exposures.

suggested that today's hedge accounting restrictions regarding eligible hedged exposures and hedging instruments be relaxed to move even closer to their ALM process.

7. The following sections address certain issues identified by the banks in greater detail and discuss whether clarifications to IAS 39 might be necessary.

CASH FLOW SCHEDULING

8. In determining the ***economic*** interest rate exposure, each bank forecasts future cash flows arising from the repricing of existing contracts as well as interest rate exposure from forecast refinancing and reinvestments. It is on this basis that ALM decisions are made and hedging transactions entered into. Hedge accounting is then overlaid onto the ALM process.

9. The banks noted that the schedule of future cash flows used for ALM purposes is based on conservative assumptions about contractual and economic behavior. The assumptions are reviewed regularly to ensure their validity.

10. The banks apply a number of techniques to ensure that forecast cash flows are highly probable to satisfy the requirements in IAS 39. For example, many banks only designate some (but not all) of the forecast cash flows available in each period. The amount designated might depend upon factors such as the historical volume stability of the underlying items. For example, the reinvestment of cash flows in future loans might be historically stable and highly predictable, and so the bank would designate a relatively high amount of the total available forecast cash flows arising from such future loans.

11. Each bank and its auditor took a similar approach to ensure that forecast cash flows are highly probable. There was little or no demand from any of the banks for more guidance regarding what is or is not considered to be highly probable.

12. All of the banks used buckets of one month or longer to schedule cash flows. The time buckets chosen were to be consistent with ALM practice and to provide a practical level of granularity given system capabilities. There was

no suggestion from any bank (or its auditor) that IAS 39 required cash flow buckets to be calculated on a daily basis.

13. The banks primarily used the portfolio cash flow hedge accounting model for cash flow exposures for the next 3 to 5 years. Exposures beyond that were generally either not designated for hedge accounting purposes, or designated on an individual basis. This reflected both internal risk management practice as well as reduced liquidity for longer dated hedging instruments in some situations (see paragraph 24).

SPECIFIC IDENTIFICATION OF FORECAST TRANSACTIONS

14. In determining future cash flows, the banks typically create separate pools for items that have different repricing characteristics. It is against these separate pools that hedge accounting designations are subsequently made. The segregation of items into separate pools is for risk management purposes only; the bank is primarily interested in being able to determine (to the greatest degree of accuracy possible) that an economic interest rate exposure in a particular period exists.

15. For portfolio cash flow hedge accounting designation purposes, the fact that the bank has an interest rate exposure in a certain time bucket is considered sufficient. No bank considered it necessary, for accounting purposes, to identify whether an interest rate cash flow exposure arises from forecast fixed or floating interest rate items. This is consistent with the explicit requirements in IG F.6.3.

THE INTEREST RATE ENVIRONMENT

16. As previously mentioned, we had discussions with banks that have operations in many different geographical markets. In some markets, most interest rate assets and/or liabilities are variable rate. In other markets, most interest rate assets and/or liabilities are fixed rate.

17. We have previously been told that the application of portfolio cash flow hedge accounting in markets that both assets and liabilities are predominantly fixed rate is problematic. One of the reasons given related to the identification and

designation of forecast cash flows arising from the reinvestment of assets (or refinancing of liabilities).

18. We spoke with banks that operate in such markets and ***for ALM purposes*** have either:

    a. *An asset gap* (assets having shorter duration than liabilities) – and therefore the bank enters into a forward starting receive fixed/pay floating interest rate swap, or

    b. *A liability gap* (liabilities having shorter duration than assets) – and therefore the bank enters into a forward starting receive floating/pay fixed interest rate swap.

19. For ***hedge accounting purposes*** the banks that have the *asset gap* designate existing floating rate assets (to the extent they are available), and the future origination of interest rate sensitive assets.

20. For ***hedge accounting purposes*** the banks that have the *liability gap* designate existing floating rate liabilities (to the extent they were available) and the future issuance of interest rate sensitive liabilities. If insufficient interest rate sensitive liabilities are available then the banks either designate existing fixed rate assets in a fair value hedge or do not seek hedge accounting.

21. In both situations, the banks successfully apply the IAS 39 portfolio cash flow hedge accounting model.

DESIGNATION OF THE HEDGED ITEM

22. The aim of all the banks was to designate the hedged items in a way that minimized ineffectiveness. For most banks, that meant applying a designation methodology very similar to that set out in IG F.6.3.

THE HEDGING INSTRUMENT

23. All of the banks used interest rate swaps as hedging instruments in designated portfolio cash flow hedge accounting relationships. One bank also used strips of interest rate futures contracts for shorter dated cash flow exposures.

24. Most of the interest rate swaps designated in portfolio cash flow hedge accounting relationships had maturities of 3 to 5 years. As discussed previously, some banks had a policy of not attempting to designate longer-dated swaps in a portfolio cash flow hedge accounting relationships. Other banks only did so on relatively few occasions and in very restricted situations.

EFFECTIVENESS

25. All of the banks had fairly similar approaches to evaluating effectiveness for qualification purposes and measuring actual effectiveness. This included the use of regression analysis to ensure high correlation between interest rate indices, the use of capacity tests to ensure that the designated bottom 'layer' of cash flows had not been breached and the use of "hypothetical derivatives"[2].

26. All the banks measured actual effectiveness, with any ineffectiveness being recognized in profit or loss. Ineffectiveness typically was minimal and arose from any basis mismatch between the hedged item and the hedging swaps (although in some situations some banks also entered into basis swaps to eliminate that source of ineffectiveness).

27. A number of banks remarked upon difficulties in creating "hypothetical derivatives" for testing effectiveness (for example, determining the features to be included). This issue is relevant to the application of cash flow hedge accounting generally (not just portfolio cash flow hedge accounting). It was suggested by some that more guidance in this area might be useful.

28. Another issue related to situations in which the bank wanted to improve documentation or the method used to determine effectiveness. In such situations practice is to dedesignate the existing hedging relationship and designate a new hedging relationship. However, this may result in ineffectiveness if the hedging instrument has a fair value other than zero at the time the new hedge accounting relationship is designated. This creates no incentive to improve documentation or effectiveness testing of outstanding

[2] A hypothetical derivative mimics the cash flows designated as being hedged. This technique allows the variability of the designated cash flows to be measured and compared to the fair value changes of the designated hedging instrument. This technique is commonly used to assess retrospective effectiveness (for hedge accounting qualification purposes) and actual effectiveness.

hedge relationships. Once again, this issue applies to hedge accounting in general (not just portfolio cash flow hedge accounting).

RECLASSIFICTION OF GAINS/LOSSES

29. The mechanism used by most of the banks to reclassify gains/losses on designated hedging instruments from equity to profit or loss is the accrual mechanism arising from interim cash settlements on the interest rate swaps.

30. However, if a hedging instrument is dedesignated, the deferred gains/losses are reclassified over a period of time. There appears to be some confusion as to what that period should be, and some suggested that this could be clarified (see paragraphs 97 to 101 of IAS 39).

DESIGNATION OF SUB-BENCHMARK INTEREST RATE ITEMS

31. There is some diversity on whether items that carry a sub-benchmark interest rate can be designated and, if so, what ineffectiveness might result.

32. For example, the liabilities of banks are (typically) sub-LIBOR. All the banks were clear that zero rate or very low interest rate liabilities could not be designated (at least, in a practical and efficient manner). However, there was some diversity on whether and/or how a liability that carried a LIBOR-50bp interest rate (for example) might be designated.

33. Some suggested that this issue should be clarified and/or reconsidered (see paragraph AG99C of IAS 39).

EXTENSION OF THE CASH FLOW HEDGE ACCOUNTING EXCEPTION

34. Although the main purpose of the meetings was to understand the issues arising from the application of the portfolio cash flow hedge accounting model, some banks also requested the IASB to consider whether cash flow hedge accounting should be available in more situations than is the case today.

35. One common situation was when funding is in a currency other than the entity's functional currency and is then swapped back into the entity's functional currency. Today, the currency swap derivative is not eligible for

designation as part of the hedged item. So while for ALM purposes the effect of the currency swaps on future cash flows is considered, for hedge accounting purposes they are not considered. In some situations this restricts the ability of the bank to apply hedge accounting to a common risk management and funding practice.

36. This issue is broader than portfolio cash flow hedge accounting. For example, the Board has been asked on many occasions to consider this issue by corporate treasurers. IAS 39 does not cater for such situations. However, any changes to IAS 39 in this area would be more than a clarification of IAS 39 and would also extend the scope of cash flow hedge accounting (that is itself an exception to normal accounting principles).

EXTERNALISATION OF HEDGING INSTRUMENTS

37. To be eligible for hedge accounting designation any hedging instrument must be with a counterparty that is external to the reporting entity. This requirement results in banks entering into a greater number of derivatives with external counterparties than economically they might otherwise. This creates additional cost and complexity.

38. This issue is not unique to banks applying portfolio cash flow hedge accounting. However, it does have added implications for banks (for example, regulatory capital that may be required for counterparty risk). Once again, any changes to IAS 39 in this area would be more than a clarification of IAS 39.

SUMMARY

39. Based on the discussions with the banks, the staff has concluded that *on the whole* no clarification is required regarding the forecasting of cash flows for portfolio cash flow hedge accounting purposes. Specifically, the staff has concluded that:

    a. No additional guidance is required on how to apply the IAS 39 requirement that designated forecast cash flows are ‘highly probable’ (see paragraphs 8 to 13).

b. IG F.6.3 is clear that, in designating the interest rate exposure arising from future cash flows, there is no requirement to identify whether an interest rate cash flow arises from exposure to forecast fixed or floating rate items (see paragraphs 14 and 15).

40. However, the staff has concluded that the following specific issues could be clarified or reconsidered:

    a. What is meant by a "hypothetical derivative" for testing effectiveness (see paragraph 27).

    b. Improvement of documentation/effectiveness methodology applied to existing hedge relationships (see paragraph 28).

    c. The period in which deferred gains/losses should be reclassified if a hedging instrument is dedesignated (see paragraph 30).

    d. Designation of sub-benchmark interest rate items (see paragraphs 31 to 33).

41. Some of these issues relate to the general application of hedge accounting (not just the application of portfolio cash flow hedge accounting). Each of these issues also requires further analysis before the Board would be able to decide *what* clarifications might be made. Therefore, should the Board wish to consider addressing some or all of these issues, the staff will prepare additional materials for the Board; this will include recommendations as to *how* any possible clarifications might be made (for example, as part of the proposed amendment on hedge accounting or as part of the annual improvements process).

42. **Question to the Board:** Does the Board wish to consider addressing some or all of the issues set out in paragraph 40?