
Project	Financial Instruments (Replacement of IAS 39) – Hedge Accounting
Topic	Macro hedge accounting – hedge accounting that is consistent with risk management

Introduction

Background and purpose of this paper

1. This paper is one of a series of papers that discusses portfolio fair value hedge accounting for interest rate risk. Agenda paper 10 provides an overview of the papers to be discussed.
2. In paper 10A, the staff noted the following key points:
 - (a) When hedging interest rate risk, a key objective of a bank is to stabilise net interest margin over a given period (eg 5 to 7 years);
 - (b) A bank would typically under-hedge its interest rate exposure;
 - (c) A bank hedging interest rate risk will consider both fixed rate and floating rate assets and liabilities together and not focus only on one type of instrument (eg fixed or floating) on one side of the balance sheet (eg asset or liability); and
 - (d) Matching interest cash flows on both sides of the balance sheet, not only reduces cash flow variability but also reduces fair value variability due to changes in interest rates. However, the risk management objective is not to fully offset the fair value change of pre-payable items due to changes in interest rates. It is to stabilise net interest margin.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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3. This paper discusses, at a high-level, the hedge accounting alternatives available and discusses whether they effectively portray the economic objective of a bank that hedges interest rate risk on prepayable fixed rate assets/liabilities on a portfolio basis.
4. There are no questions to the Board in this paper.

Hedge accounting alternatives

General model

5. As described in paper 10A, interest margin volatility arises from a mismatch between fixed interest cash flows (paid or received) and floating rate interest cash flows (received or paid). Hence, at first glance it would appear that, under the existing hedge accounting architecture of IAS 39, an entity has two alternatives for interest rate hedge accounting:
 - (a) It could cash flow hedge account the cash flow variability arising from (current and future) eligible floating rate assets and/or liabilities; or
 - (b) it could fair value hedge account eligible (existing) fixed rate assets and/or liabilities (including the use of the 'macro hedging' provisions).
6. However, given that an entity hedges the net portfolio of fixed and floating rate items, neither of these approaches is a true representation of the risk management objective.
7. Despite this, both methodologies do provide an opportunity for an entity to present interest income/expense in profit or loss on a hedged basis (and thereby match interest cash flows). However, in practice, both methods have their shortcomings which can make hedge accounting difficult or impossible to apply. Furthermore, where hedge accounting is achieved the accounting tends to give rise to hedge ineffectiveness that is not a fair representation of the economic hedge ineffectiveness (ie the ineffectiveness of the hedge relationship as viewed from a risk management perspective).

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8. Given a choice between cash flow and fair value hedge accounting, entities would tend to prefer fair value hedge accounting because under fair value hedge accounting an entity can attempt to achieve matching in profit or loss as well as on the balance sheet. For example the fair value hedge accounting mechanics:
- (a) converts fixed interest income/expense on the hedged item into market floating rate interest income/expense (eg 3-month LIBOR), which can be matched with other floating rate cash flows in profit or loss (hence stabilise interest margin); and
 - (b) allows for the recognition on the balance sheet, and in profit or loss, the change in fair value of the fixed rate cash flows due to interest rate risk, which can offset hedging instrument gains/losses. Recognition of this offsetting fair value change reduces equity volatility that arises from cash flow hedge accounting¹.
9. For a bank that hedges interest rate risk on a portfolio basis, the fair value hedge accounting model would provide a suitable solution to present the hedge relationship if:
- (a) hedge ineffectiveness recognised was consistent with the hedge ineffectiveness identified from a risk management perspective;
 - (b) the actual hedged items and hedging instruments that exist from a risk management perspective were eligible from an accounting perspective; and
 - (c) application of the model (eg testing for effectiveness) was operational.

Portfolio model

10. The complexities of the hedged item (described in agenda paper 10A) means that in practice the general fair value hedge accounting model cannot be applied

¹ The importance of this feature for banking financial statements was evidenced by the feedback received to the Board's past tentative decision (since amended) to treat fair value hedges in the same way as cash flow hedges.

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to portfolios. It is for this reason that IAS 39 has a separate model for PFVHA hedges.

11. The PFVHA model attempts to accommodate many of the complicating factors that arise in practice. In doing so, the model adapts some of the requirements that apply to fair value hedges of individual items, including some concessions to address a portfolio context. Despite these amendments and concessions, the model has still been heavily criticised by preparers and/or users for not:
 - (a) providing useful information;
 - (b) being operational; and
 - (c) being consistent with the risk management objective.
12. This prompts us to reconsider whether the PFVHA model makes the right amendments and concessions, and whether other approaches could better address the issues that arise

Next steps

13. The next steps are to analyse the issues that arise under the PFVHA model in more detail and consider potential alternative solutions.
14. The next paper in this series is agenda paper 10C. This paper highlights the hedge ineffectiveness issues that arise from a *proportional* approach to identifying and designating the hedged item.