STAFF PAPER

Week beginning 12 December 2011

Project	**Macro Hedge Accounting**		
Paper topic	Valuation of the risk position (steps 1 to 3) – Cover paper		
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Purpose

1. The purpose of this paper series is to provide a more detailed discussion of alternatives for the valuation of the risk position as briefly introduced with agenda paper 7A of the November 2011 IASB meeting. It relates to steps 1 to 3 explained there.
2. **Agenda paper 4A** discusses a full fair value measurement approach for the risk position (step 1) in comparison to a valuation that is limited to fair value changes attributable to the hedged risk (step 2). The focus is on the differences in the financial statement information provided with both approaches. Also, alternatives for the determination of the fair value change attributable to the hedged risk (here interest rate risk) are discussed.
3. **Agenda paper 4B** is comparing a valuation based on fair value changes attributable to the hedged interest rate risk (step 2) with the risk management objective of stabilising an interest margin (step 3). This section basically discusses the appropriate benchmark interest rate to be used for the determination of the hedged interest rate risk. The differences in respect of financial statement information provided with both approaches are highlighted.
4. In essence, the focus of the discussion in these papers is on the appropriate discount rate for the valuation of risk positions as the key driver of a present value calculation. Future papers will then focus on the underlying cash flow pattern

discussing topics like using a portfolio as unit of account, layer approaches and core demand deposits.

5. There are no questions to the Board in these papers.

Summary of both papers

6. The papers discuss three alternatives for the measurement of the hedged risk:

   (a) Full fair value measurement.

   (b) Fair value measurement attributable to the hedged risk (interest rate risk).

   (c) Measurement addressing the margin hedge objective.

7. Comparing the alternatives in respect of the information that they provide to the users of the financial statements the following distinction can be made:

   (a) **Full fair value measurement:** transparency in respect of the (fictitious) sales price of the hedged item and the offsetting hedging effect. Therefore the mismatch accounted for in profit or loss represents the unhedged portion of the fictitious sales price with additional disclosures on the measurement of those fair values.

   (b) **Fair value measurement attributable to the hedged risk:** transparency in respect of the (fictitious) sales price but limited to its interest rate risk element. A mismatch accounted for in profit or loss represents the unhedged portion of this risk.[1] Additional disclosures need to explain how this value is determined (selection of benchmark interest rate).

   (c) **Measurement addressing the margin hedge objective:** transparency in respect of the margin risk associated with a fixed rate instrument. For example, a negative valuation indicates a negative impact on the future

[1] 'Unhedged' in this context could mean not hedged (in the sense of leaving an open risk position), not perfectly hedged (in the sense of mismatches between the hedging instrument and the risk position it is addressing) or over-hedged (the hedging instruments are not covered by an offsetting risk position).

margin when not compensated or hedged.[2] The reverse logic applies to a positive valuation. A mismatch accounted for in profit or loss indicates to what extent those margin risks are hedged[3]. Additional disclosures are required to explain the determination of the margin, ie the selection of the benchmark interest rate.

8. Given the number of items affected by macro hedge accounting the decision on the accounting model is as pervasive as a categorisation discussion. For example, for financial institutions almost the entire non-trading interest-bearing financial instruments would become subject to macro hedge accounting.

9. As such it needs to be decided whether the model is supposed to reflect a fictitious business purpose (ie a fictitious sale of the financial instruments on the market) even in situations where the actual business and risk management activities are to hold the instruments in the normal course of business and protect the calculated net interest margin. This relates to the discussion of the primary indicator for performance in the light of the business model applied.

10. Therefore the level of transparency provided through the discussed alternatives is dependent on what information the financial statements are supposed to provide. More specific: *To what extent should the business model from which investment, funding and risk management decisions are derived from be reflected in the financial statements?*

11. Comparing the alternatives regarding the level of management judgement involved the following considerations apply:

    (a) As long as the full fair value is based on quoted prices in active markets (level 1) or can be determined on the basis of observable inputs (level 2) the full fair value approach is more objective.[4]

    (b) This changes as soon as the inputs are non-observable (level 3). This is a common situation given that the business model is not focussed on

[2] For example: For a financial asset a negative valuation adjustment indicates that the current funding rate is higher than originally planned. It represents the present value of the negative impact on the future margin.

[3] For an interpretation of unhedged margin risks refer to the discussion in footnote 1 above.

[4] However, it has to be considered that even fair values that are based on level 2 inputs involve some subjectivity.

regular sales transactions and therefore respective market transactions that could serve as an indicator are rather rare.[5]

12. When comparing a level 3 full fair value with the three alternatives discussed in agenda paper 4A for the isolation of the hedged interest rate risk it can be noticed that the effect of the cash flow pattern is rather small while the setting of the discount rate is the key driver for the measurement.
13. On that basis all three approaches require the selection of a benchmark interest rate as a basis for the discount rate following different considerations (sales transaction versus interest margin). In addition, the full fair value calculation requires the determination of the additional margin elements a market participant would demand to cover credit risk and other risk elements. For the other three alternatives these would not be taken into account because the re-measurement is limited to risk being addressed through interest rate risk management.
14. Therefore the determination of a level 3 full fair value introduces the highest level of judgement as inputs for all valuation aspects have to be determined on the basis of non-observable information.
15. On the face of it, the selection of the benchmark interest rate following full fair value measurement criteria seems to be the more objective solution. In contrast, the benchmark interest rate for the calculation of the margin follows internal risk management decisions and can be determined on the basis of the chosen risk management approach and objective.
16. However, although the benchmark interest rate usually represents an observable input (level 2) for fair value measurement in accordance with IFRS 13 there is judgement involved in respect of the selection of the benchmark rate. The determination in alignment with the risk management approach has the advantage that it provides information on actual risk management decisions. Separately exercising judgement solely for accounting purposes can always lead to disconnects from actual business decisions (*...'for accounting purposes it is assumed that'*…).

[5] As explained in both agenda papers: The business model is also dependent on strategic funding or investment decisions and restrictions. For example, there are markets where securitisations and sales transactions represent a key source of funding. This would also be reflected in the set-up of the risk management function and its objectives.