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Project	<b>Macro Hedge Accounting</b>		
Topic	<b>Considerations for a macro hedge accounting concept Conceptual alternatives</b>		

## Introduction

1. The purpose of this paper is to discuss alternatives for macro hedge accounting models. The analysis is based on a common interest rate risk management approach as described in **agenda paper 9A** and should be read in conjunction with that.
2. The conceptual considerations in this paper address differences between the described risk management approach and the current hedge accounting requirements, ie IAS 39 *Financial Instruments: Recognition and Measurement* as well as the exposure draft on the general hedge accounting model (ED) as highlighted by **agenda paper 9B**.
3. This paper introduces general conceptual alternatives for the development of a macro hedge accounting model.
4. There are no questions to the Board in this paper.

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.

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**Background for considerations of potential accounting approaches**

5. The deliberations regarding macro hedge accounting are based on the general principles of IFRS 9 *Financial Instruments*. The objective of IFRS 9 is to establish principles for the financial reporting of financial instruments that present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows.
6. IFRS 9 uses the way financial assets are managed ('business model') and their contractual cash flow characteristics to classify those assets for measurement purposes. For financial assets that are managed with the objective to hold them in order to collect contractual cash flows and with contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding subsequent measurement is at amortised cost (unless an entity uses the fair value option, if applicable). For the classification of financial liabilities the Board carried over large parts of the requirements of IAS 39, which results in amortised cost as the default measurement (with financial liabilities held for trading or for which the fair value option is used being measured at fair value).
7. Given their specific characteristics derivatives are accounted for at fair value through profit or loss when they are not designated and effective hedging instruments. This prohibits classification of derivative financial instruments as measured at amortised cost.
8. The predominant part of the hedged items covered by the risk management approach as described in agenda paper 9A are financial instruments accounted

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for at amortised cost or will become such instruments, which refers for example to pipeline trades or loan commitments<sup>1</sup>.

9. The analysis in agenda paper 9B has shown that the impact of the conceptual differences between hedge accounting following current hedge accounting requirements and common interest rate risk management approaches. This relates to the determination of ineffectiveness to be recognised in profit or loss as well as the amortisation of the hedge adjustment or the release of other comprehensive income (OCI) (dependent on the hedge accounting model) when discontinuing hedge accounting because of changes in the portfolio. Although IAS 39 provides some flexibility regarding the designation of hedge accounting to address this issue it is only directionally consistent with risk management.
10. Therefore this paper analyses potential alternatives for a macro hedge accounting model and how those correspond with the general objectives of IFRS 9 regarding the presentation of the financial performance. Although the different conceptual features will be discussed individually it is important to note that those should not be analysed in isolation from the entire comprehensive risk management approach.
11. The analysis in this paper is based on the following key assumptions:
  - (a) The scope is to develop a hedge accounting solution rather than changing the classification of financial instruments, ie the assumption that derivatives are accounted for as at fair value through profit or loss unless they qualify as *effective* hedging instruments is untouched.
  - (b) Similar to the general hedge accounting model, the macro hedge accounting model aims to facilitate a better reflection of risk management where it can be accommodated within accounting (alignment).

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<sup>1</sup> See agenda paper 9A (section 'Other instruments') for a more detailed discussion of transactions subject to interest rate risk management.

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12. As a consequence of the first key assumption one possible approach might be to account for derivatives at cost (accrual accounting) as long as it can be demonstrated that those are subject to a macro risk management strategy. This follows the fact that banks usually do not distinguish between derivatives and non-derivatives but are rather focussed on the entire portfolio development. It would also address the fact that the hedged items are also accounted for at cost in line with the business model.
13. However, especially with sophisticated risk management strategies that are focussed on achieving a target return or allowing running open positions this could in effect lead to situations in which derivatives that are not directly linked to a non-derivative hedged item are accounted for at cost. Dependent on the criteria for adopting this concept especially in respect of effectiveness testing it is in essence applying the business model related classification criterion of IFRS 9 to derivatives entered into for a certain business purpose rather than the application of hedge accounting that deals with differences resulting from the mixed measurement model. This is not in the scope of the macro hedge accounting project as outlined.
14. The second key assumption relates to the objective of the ED to improve the link between risk management and hedge accounting. However, the objective is not to simply adopt the treatment used for risk management (eg accrual accounting for derivatives) in all circumstances but instead to facilitate a risk management view to the extent that it can be accommodated within the accounting framework. For example, the general hedge accounting model has still been founded on measuring and recognising hedge ineffectiveness as one of the cornerstones. It is hard to achieve a complete alignment with risk management given the different purposes of financial reporting and risk management, the variety of risk management practices and the on-going development in this area.

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However, focussing only on accounting anomalies is also considered as being too narrow as a basis for the deliberations on macro hedge accounting.<sup>2</sup>

**Conceptual steps**

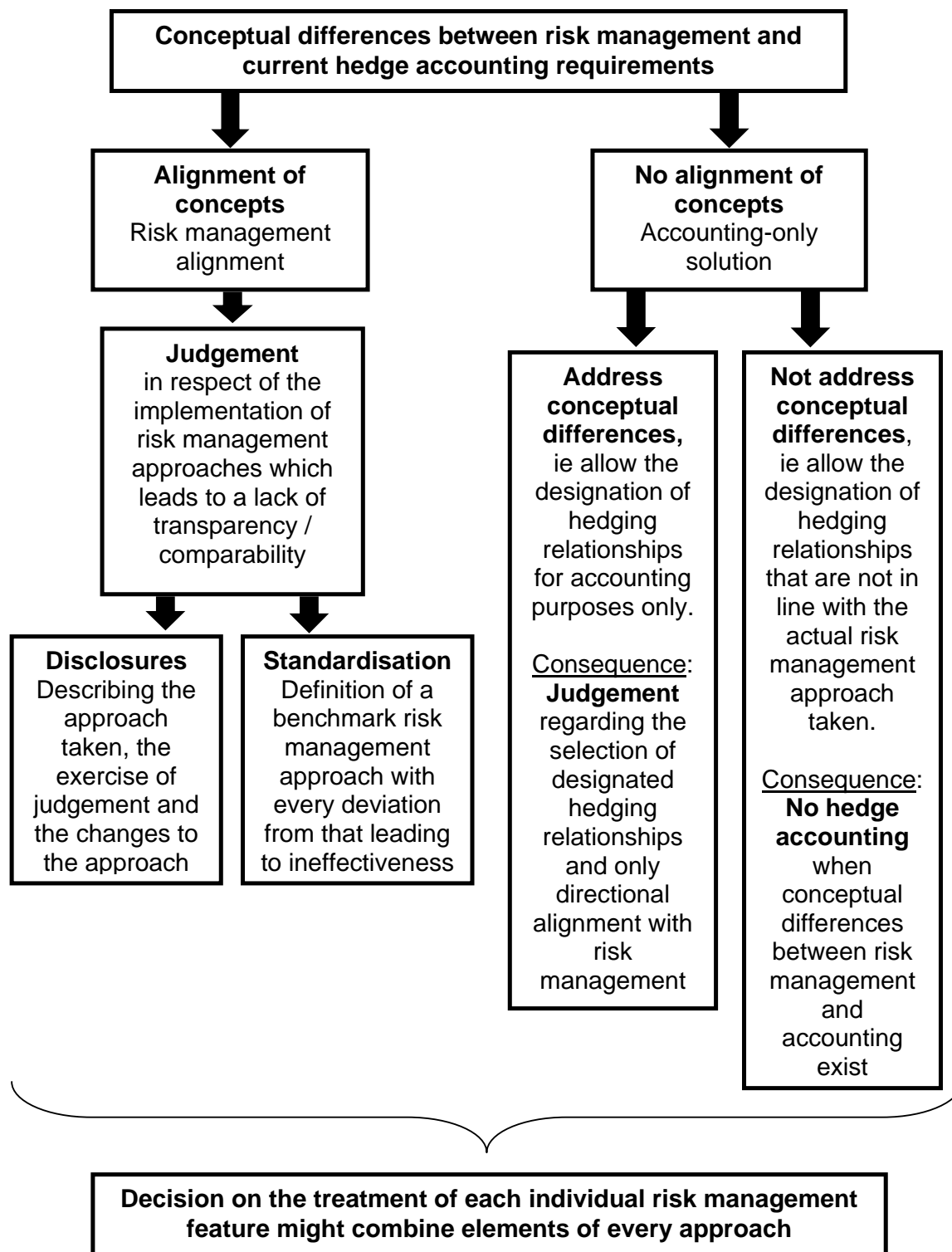
15. Agenda paper 9B focussed on conceptual differences between current accounting and risk management. The key differences regarding the risk management are:
  - (a) Focus on the stabilisation of a net interest margin,
  - (b) Focus on the portfolio as unit of account.
16. The first topic addresses the fact that although risk management identifies risks on the basis of fixed rate instruments the real objective is not to hedge fair value risk. This corresponds with a business model to hold assets in order to collect contractual cash flows, which is also the basis for amortised cost accounting of those instruments. The concept of treating the open portfolio as the unit of account addresses mainly the dynamic nature of the risk management approaches taken as well as the fact that all identified risk positions are subject to one uniform risk management approach.

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<sup>2</sup> Refer to the ED paragraphs BC11 to BC16.

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17. The conceptual alternatives are summarised in the following chart:



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18. The starting point of a uniform concept for macro hedge accounting is to decide on how to deal with the conceptual differences that have been identified. This leaves the alternatives to either align the accounting requirements to the risk management approach or to create an accounting-only solution with a different degree of conceptual alignment.

***Alignment of concepts***

19. An alignment with risk management would require opening the accounting requirements in a way that the risk management view (or elements thereof) become a basis for hedge accounting.
20. Beside a general risk management framework that forms the basis for the approaches taken by individual entities the actual implementation of those approaches is a decision by the entity's management reflecting its individual preferences. Taking risk management as a basis could therefore create a number of implementation choices, which has to be addressed:
  - (a) Different management decisions lead to a lack of transparency and comparability when not further explained or otherwise providing transparency.
  - (b) Approaches taken on the basis of management judgement might be subject to changes creating accounting consequences.
  - (c) The flexibility provided by allowing management judgement could be abused to achieve a favourable accounting consequence.
21. There are two main concepts available to address differences regarding implementation choices applied:
  - (a) Provide further information on the approach taken. This would basically lead to the introduction of further disclosure that describes the risk management features used and how they were implemented. This should provide information regarding the definition of the hedged risk

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(hedged transactions and components), risk management objective, hedging instruments used and how the effectiveness of the hedging relationship is determined whereby some of this information might create commercial sensitivity issues. An important element is to provide information about changes in risk management approaches and policies as those usually will have a direct consequence for the effectiveness of the hedging relationship when risk management is used as a basis for accounting. For this topic it has to be discussed to what extent those changes would be just subject to disclosure, lead to fair value volatility to be reflected in profit or loss or result in a discontinuation of the entire hedging relationship.

- (b) The second alternative listed above is to establish general principles for the application of macro hedge accounting (standardisation). This has the consequence that any deviation from the 'standardised approach' directly impacts the financial statements. Usually, specifying a standardised approach increases the level of volatility in profit or loss as it leads to the non-qualification of risk management approaches regarding hedged items (including any designations of risk components) or hedging instruments. This approach would in essence require determining a benchmark risk management approach for accounting purposes with any deviation from that leading to 'ineffectiveness'. However, the difficulty is to agree on a benchmark that could be considered as being most representative for interest rate risk management.

***No alignment of concepts***

- 22. Another approach would be to accept the difference between risk management and accounting without trying to achieve a closer alignment. As a consequence hedge accounting could not be based on many common interest rate risk management strategies.



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23. In a first step this could lead to hedge accounting being unavailable because of conceptual differences. In other words, the implicit statement of the accounting guidance would be that the described macro hedging strategies would not be accommodated for accounting purposes, which is another (albeit indirect) form of setting a benchmark for risk management.
24. To overcome this consequence the standard might allow designating hedging relationships for accounting purposes only, ie accept that there are differences between the actual risk management strategies and what is designated for the purpose of financial information.
25. This consequently introduces another level of management judgement as preparers would have to decide on the level of hedging relationships that they want to designate. However, given conceptual differences between risk management and accounting the financial statement presentation would only *directionally* reflect actual risk management anyway.
26. Furthermore, the management judgement involved when selecting hedging relationships for accounting purposes has similar consequences as discussed for an approach that aims to align accounting more closely with risk management<sup>3</sup> and should be addressed accordingly. One alternative to address that are disclosure requirements that provide a link between the actual risk management strategy and how this is reflected in the financial statements highlighting significant differences.

***Combine elements of both conceptual alternatives***

27. Finally, it could be considered to decide the alternatives outlined above for the different risk management features individually<sup>4</sup> and therefore end up with a macro hedge accounting model that combines risk management and accounting

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<sup>3</sup> See the diagram in paragraph 17 ('alignment of concepts').

<sup>4</sup> The expression 'risk management features' refers to the various elements of common interest rate risk management approaches as discussed in agenda papers 9A and 9B.

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elements. This would reflect the objective of the ED to establish principles that lead to financial reporting being *better aligned* with risk management without simply adopting the treatment for risk management purposes as the accounting solution. However, for this it must be considered that there are interdependencies between the different features and therefore choices regarding one feature have implications for the choices regarding other features if the final approach should not become piecemeal.

**Summary**

28. The following table summarises the four alternatives introduced and highlights their impact on the financial statement presentation. It is followed by an example that applies these alternatives to pre-payable loans:

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Topic	Alternative 1 ‘Accept risk management approach including risk management policies’	Alternative 2 ‘Accept a risk management approach but restrict entity specific risk management policies’	Alternative 3 ‘Deny risk management approach but provide accounting policy choices instead to bridge the gap’	Alternative 4 ‘Definitely deny risk management approach’
<b>Conceptual alternatives</b>	Alignment with risk management treating management judgement like an accounting policy choice.	Alignment with risk management approach limiting management judgement using standardisations. Deviations of the actual risk management policies create fair value volatility from the ineligible part of hedged exposure.	No direct alignment with risk management but flexibility regarding the designation of hedging relationships to address restrictions, if directionally consistent.	No alignment with risk management. Conceptual differences between risk management and accounting lead to the denial of hedge accounting.
<b>Financial statements impact</b>	Provides risk management view of the entity’s performance whereby only deviations from the entity-specific risk management approach impact profit or loss.	Provides (standardised) risk management view of the entity’s performance whereby any deviation from a standardised risk management approach (benchmark) impacts profit or loss.	Derivatives for which an offsetting hedged item can be found do not create volatility in profit or loss. Can provide similar view as alternative 1 dependent on the selection of derivatives and hedged items and the availability of qualifying hedged items.	Because of the conceptual differences between risk management and the general hedge accounting requirements the derivatives would be accounted for at fair value through profit or loss without considering offsetting hedged items.
<b>Expected volatility on net income</b>	<b>Low</b> because of the high degree of alignment with the entity-specific risk management approach.	<b>Depends</b> on the gap between the benchmark risk management approach and the actual risk management activities.	<b>Depends</b> on the availability of alternative hedged items that fit to the derivatives and the frequency of re-designations.	<b>High</b> because of missing consideration of risk management aspect.
<b>Information conveyed by profit or loss</b>	Actual risk management activities result in ineffectiveness compared to the entity-specific risk management approach.	Actual risk management activities result in ineffectiveness compared to a benchmark risk management approach.	The hedged items available do not perfectly fit to the derivatives and / or frequent re-designations are required to reflect the dynamics of the actual risk management strategy.	There is no directly related offsetting risk position for the hedging instruments.
<b>Comparability</b>	Differences regarding the actual risk management approach taken would only be addressed in the disclosures to the financial statements.	Differences regarding the actual risk management approach taken would become visible through a different level of volatility in profit or loss.	Differences in the financial statements result from different implementation of hedge accounting, driven by different balance sheet structures, product-types, operational considerations.	Differences in volumes of derivatives become visible through volatility in profit or loss. Provides only very indirect information on the risk management approach taken.

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**Example: Pre-payable loans**

29. As an example the conceptual alternatives outlined are applied to the treatment of the optionality risk inherent in pre-payable loans. For this the risk management activities applied vary, eg the optionality risk is hedged with respective hedging instruments or it is taken into account when determining expected cash flows on a portfolio level. This leads to the following alternatives in respect of the accounting treatment:

- (a) Alternative 1—The accounting requirements accept that optionality risk is a separate sub-element of interest rate risk that might be addressed in different ways. Hence, whether it becomes part of the hedged risk for hedge accounting purposes is dependent on the risk management policy applied. As a consequence net income reflects the ineffectiveness resulting from valuation differences between the hedged risk (as determined individually) and the hedging instrument. It indicates the extent an entity meets *its own* risk management objectives.
- (b) Alternative 2—As with alternative 1 the accounting requirements accept that optionality risk is a separate sub-element of interest rate risk and therefore the hedging relationship can be designated for accounting purposes. However, unlike alternative 1 changes of optionality risk that are attributable to the hedged interest rate risk have to be reflected in profit or loss, even when un-hedged. This is to visualise differences in the risk management policies as income volatility. Beside the ineffectiveness described in alternative 1 net income also reflects the volatility resulting from optionality risk (when un-hedged). It indicates to what extent the entity met the standardised risk management objective to hedge the entire interest rate risk of the designated transactions.

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- (c) Alternative 3—The approach of treating optionality risk as a sub-element of interest rate risk is denied for accounting purposes and therefore only the entire interest rate risk can be designated as the hedged risk. This leads to a source of ineffectiveness when the hedging instrument does not contain reverse optionality. However, to cope with this restriction a different hedged item of the portfolio (without prepayment risk) can be designated on a gross basis, when available. Net income reflects the ineffectiveness of the hedging relationship set-up for accounting purposes. Whether un-hedged optionality risk leads to volatility is then dependent on the possibility to substitute the pre-payable for non-prepayable loans.
- (d) Alternative 4—Denying the approach of treating optionality risk as a sub-element of interest rate risk with the consequence that hedge accounting is not applicable as the risk management strategy cannot be reflected within the accounting requirements. Net income reflects the fair value change of the hedging instruments. It provides information about the extent hedging instruments are used but not about the effectiveness of the risk management activities because of the missing link to the hedged risk.