STAFF PAPER

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IASB Meeting

Project	**Macro Hedge Accounting**		
Paper topic	Next due process step: Discussion paper versus exposure draft		

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Introduction

1. This paper evaluates a *procedural aspect* of the macro hedge accounting project: whether the next due process step should be a Discussion Paper (DP) or an Exposure Draft (ED).

2. Based on this evaluation, the staff recommend that in order to develop a new macro hedge accounting standard it would be appropriate to work first towards a DP rather than an ED.

3. This paper asks the Board whether it agrees with that recommendation.

Where we are

4. On the basis of research and the outreach activities to date, four areas shown below have been identified as common features of risk management practice in the financial services industry:

   (a) Risk management strategies are based on a net open portfolio as a unit of account.

   (b) The focus is on net interest margin as the hedged risk.

   (c) Management of cash flow optionality (eg prepayments) is based on expected cash flows and (economic) layer approaches at a portfolio level.

(d) Multi-dimensional targets are set for the risk management activities.

5. In the light of the above features, the project aims to develop an accounting solution that (a) reflects how businesses manage risk dynamically, and (b) helps users understand risk management activities. The working assumption for this project is that this aim can best be achieved by developing a separate accounting solution specifically for this form of risk management.

6. At the September 2011 meeting, the Board discussed four conceptual alternatives. As a result of that debate, the staff explored the range between alternatives 1 and 2, which take into account the risk management approach in developing a macro hedge accounting model.

<table>
<tr><th>Alternative 1</th><th>Alternative 2</th><th>Alternative 3</th><th>Alternative 4</th></tr>
<tr><td>Accept risk management approach,
including risk management policies</td><td>Accept a risk management approach,
but restrict entity specific risk management policies</td><td>Don’t accept risk management approach,
but provide accounting policy choices instead to bridge the gap</td><td>Don’t accept risk management approach</td></tr>
<tr><td colspan="2">Development of a new macro hedge accounting</td><td>Proxy-solution (IAS 39)</td><td>No macro hedge accounting solution</td></tr>
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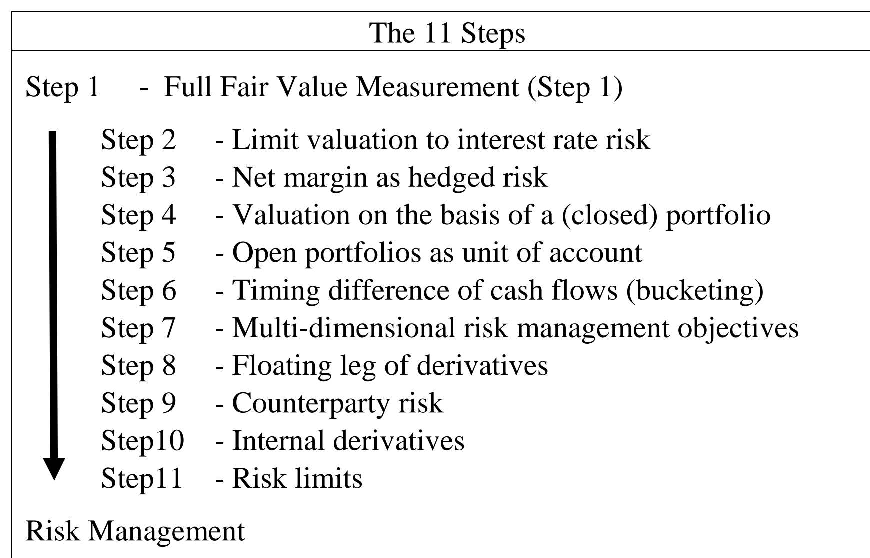
7. In line with the direction of the Board discussions, a *valuation approach* is being explored, where for accounting purposes the hedged risk position is identified and remeasured for changes in the hedged risk recognising the gain or loss in profit or loss. The advantages of this approach are as follows:

(a) The valuation of the risk position with gains and losses recognised in profit or loss, in combination with explanatory disclosures regarding the factors and inputs for this valuation, enhances transparency regarding the actual business and risk management activities.

(b) Economic volatility is more accurately portrayed, rather than showing volatility that arises from applying a hedge accounting model that is inconsistent with risk management.

(c) Greater opportunity to use data already available for risk management purposes, rather than imposing system and data collection requirements solely for accounting purposes.

8. As a starting point for the discussion of the valuation approach, full fair value measurement was considered. From there, 11 steps were identified that reflect the main differences between full fair value measurement and common interest rate risk management practice. Those steps are currently being discussed by the Board as a basis for a future decision about which of those risk management features could be appropriately included in the accounting model. The focus in the discussions so far has been *to what extent accounting standards can draw on risk management judgment*.



The 11 Steps

Step 1 - Full Fair Value Measurement (Step 1)

Step 2 - Limit valuation to interest rate risk
Step 3 - Net margin as hedged risk
Step 4 - Valuation on the basis of a (closed) portfolio
Step 5 - Open portfolios as unit of account
Step 6 - Timing difference of cash flows (bucketing)
Step 7 - Multi-dimensional risk management objectives
Step 8 - Floating leg of derivatives
Step 9 - Counterparty risk
Step10 - Internal derivatives
Step11 - Risk limits

Risk Management

Next due process step: Why a DP is preferable to an ED

9. The macro hedge accounting model being explored is based on a valuation approach. It is not simply a modification to hedge accounting. The macro hedge accounting model involves fundamental accounting questions, in particular the appropriate role of risk management judgment (ie to what extent it should be considered for accounting purposes). Other important aspects of developing a macro hedge accounting model are:

(a) macro hedging is a complex area, which has ramifications for the accounting;

(b) this type of hedging covers a broad range of risk management strategies, techniques and approaches—especially for sectors other than financial services and risks other than interest rate risk (those areas are still quite unfamiliar from a standard setting perspective);

(c) macro hedging has a very pervasive impact because it affects many different items and hence can have a significant effect on an entity's financial position and performance;

(d) macro hedging has significant operational aspects (it typically requires systems to capture and model risk profiles representing large groups of items, which also has ramifications for accounting);

(e) the above aspects also mean that obtaining user input on this issue is more difficult than for well-established accounting concepts and debates.

10. In that sense, we are entering new ground, and need to engage in an intensive dialogue with our audience. Because of the aspects mentioned above, it is unlikely that we could get straight to a single answer that can be tested using the format of an ED. In contrast, using a DP would allow us to seek feedback on a broader range of alternatives and ask a broader range of questions, and hence is a better medium to seek views from various parts of our audience.

11. Obtaining views from users is of particular importance. A key objective is to understand users' views so the Board can evaluate whether and how the new model would result in financial statements that provide useful information, and also to determine the appropriate position regarding how much management judgment is accommodated in the model. For instance, a DP may cover aspects such as what accounting information is more relevant:

(a) a result that reflects the particular risk management strategy of a particular entity or that enhances comparability among entities?

(b) information that represents the result of hedging activities of an entity or the result of risk management activities as a whole (ie including effects of both of hedging and non-hedging)?

Roadmap

12. A thorough development of a new macro hedge accounting through a DP and a subsequent ED will take time. This would conflict with the effective date of IFRS 9 (ie 2015), especially if macro hedge accounting continues to be considered a part of IFRS 9 that has a mandatory effective date aligned with other phases.

13. The staff consider it appropriate for the Board to separate the macro hedge accounting project from IFRS 9. This would mean that the Board could continue the development of IFRS 9 as planned, but exclude macro hedge accounting from its scope, with macro hedge accounting being progressed as a separate project with a DP as the next step. The reasons are as follows.

    (a) Postponing the completion of the entire standard on financial instruments for a particular issue relevant to a relatively small part of our audience is not appropriate. There is an urgent need for a broader spectrum of IFRS users for a stable accounting basis for financial instruments. IFRS 9 should be available as soon as possible.

    (b) From a technical point of view, macro hedge accounting can be separated from other elements of IFRS 9. IFRS 9 can operate independently of this project and as described below, the staff are of the view that constituents would not suffer adverse consequences as a result of the separation. In fact, rather they would benefit from the Board being able to spend the appropriate time needed to develop a robust solution to macro hedge accounting.

14. This interim solution would mean constituents can adopt IFRS 9 for all purposes except for macro hedge accounting, while the status quo of ‘macro’ hedging under existing IFRSs is maintained. Status quo here means *fair*

value hedge accounting for a portfolio hedge of interest rate risk in IAS 39 is retained during the development of a new macro hedge accounting model.[1] IAS 39 would be kept in place (solely) for this purpose.

Conclusion and staff recommendation

15. Development of a macro hedge accounting model based on a valuation approach which reflects risk management and judgement is a complex topic and a challenging one to find the appropriate balance between risk management and the provision of useful information that is sufficiently transparent. Considering it involves a broad range of conceptual and technical issues, the staff recommend that the Board publish a DP rather than proceeding directly to an ED. This process will enable the Board to develop more and deeper understanding of risk management activities in non-financial as well as financial industries, and to thoroughly understand views from different groups including users of the financial statements without affecting the overall timing of IFRS 9 and its mandatory effective date. As noted above, from a technical perspective this project can be separated from IFRS 9. In particular, constituents could continue to apply portfolio hedge accounting as set out in IAS 39.

Question to the Board

Macro hedge accounting—next due process step
Does the Board agree with the staff recommendation that the next due process step for the macro hedge accounting project should be to publish a DP rather than proceeding directly to an ED?

[1] 'Macro cash flow hedge accounting' is already part of the general hedge accounting model under IAS 39 (and illustrated in the implementation guidance that accompanies IAS 39—see IG F.6.2 and F.6.3). The changes to the general hedge accounting as part of the Board's IFRS 9 project would not result in changes that would make the relevant requirements more restrictive than under IAS 39.