

## STAFF PAPER

15 – 19 October 2012

## IASB Meeting

<b>Project</b>	<b>Accounting for Macro Hedging</b>		
<b>Paper topic</b>	<b>Credit risk and floating leg considerations (Steps 8 and 9)</b>		
CONTACT(S)	Jane Hurworth	<a href="mailto:jhurworth@ifrs.org">jhurworth@ifrs.org</a>	+44 (0)20 7246 6410
	Martin Friedhoff	<a href="mailto:mfriedhoff@ifrs.org">mfriedhoff@ifrs.org</a>	+44 (0)20 7246 6410

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

## Introduction

1. The purpose of this paper is to discuss steps 8 and 9 (regarding the implications of floating legs and credit risk of derivatives) of the ‘11 steps’ that the Board began discussing at the November 2011 meeting<sup>1</sup> with respect to accounting for macro hedging activities.
2. The discussions so far on accounting for macro hedging activities have focused on a revaluation model where macro hedging activity for interest rate risk is undertaken by banks. At a high level the revaluation model results in a revaluation adjustment for interest rate risk that arises on items at amortised cost for which the interest rate risk is managed on a portfolios basis. Such an adjustment should provide some offset to fair value movements from hedging derivatives.

## Fair value of derivatives—IFRS 13

3. A key assumption in this paper for both these steps is that accounting for macro hedging does *not* change the fair value measurement for derivatives in accordance with IFRS 13 *Fair Value Measurement*. All hedging derivatives will be measured

---

<sup>1</sup> See staff paper 7A.

at FVTPL, which includes fair value changes with respect to credit risk and any floating legs<sup>2</sup>.

4. The proposal discussed so far for accounting for macro hedging activities is to introduce a revaluation adjustment with respect to interest rate risk that arises on items at amortised cost and that is managed on a portfolio basis. That would result in revaluing risks that are not already at current value, with the consequence of providing some offset to changes in the fair value of hedging instruments which are already at fair value. There is no suggestion that accounting for macro hedging activities under the revaluation model should involve taking hedging derivatives out of FVTPL, either in their entirety or for particular risks.

### ***Consideration of floating leg valuations***

5. Banks typically swap fixed rate positions into floating in order to achieve a more stable net interest margin. Previous papers were implicitly based on the assumption that there is a single type of floating interest rate which has no fair value risk attached to it. In practice there is wide variation in what is meant by floating interest rate<sup>3</sup> and floating rate instruments ordinarily do attract some fair value changes<sup>4</sup> owing to interest rate fluctuations.
6. Let us consider an example: A bank has a £100m portfolio of 5 year customer loans at a fixed rate of 6%. It has issued variable rate funding for 5 years paying 3m LIBOR to fund this portfolio. As part of its risk management processes the bank wishes to reduce the sensitivity of its net interest margin to changes in interest rate risk. The bank chooses to achieve this by transacting 5-year interest rate swaps, paying fixed and receiving 3m LIBOR.

---

<sup>2</sup> A 'floating leg' is a part of a derivative that periodically resets to an index or price. Typically, the reset occurs around the beginning of the reset period and once the floating leg has been set it then becomes a fixed rate or price exposure whereas the remaining reset periods remain variable rate or price exposures.

<sup>3</sup> Variations can be owing to index eg LIBOR versus base rate, or tenor eg 1m, 3m or overnight.

<sup>4</sup> For example: Once a coupon on the floating leg of an interest rate swap has been fixed for a particular period, that coupon then becomes a fixed rate flow (until the next fixing date). Hence changes in market interest rates during that fixed period, will impact the fair value (discounted cash flow) of that flow. The shorter the fixing period then the less sensitive the fair value of the flow is to fluctuations in market interest rates.

7. In the above scenario, variability in the net interest margin owing to benchmark interest rate risk has been significantly reduced<sup>5</sup>. As noted above, the floating leg of the interest rate swap will be at FVTPL because the swap in its entirety is measured on that basis. What may need further discussion is the treatment of the floating rate funding within a revaluation model.
8. As part of a net interest margin approach, risk managers will include repricing risk from floating legs within their interest rate sensitivity calculations<sup>6</sup>. Therefore, including floating rate hedged instruments within the revaluation portfolio for accounting purposes would be consistent with risk management.
9. If the revaluation model included both the hedged fixed rate assets and floating rate funding, changes in their revaluation owing to interest rate risk should provide a good offset to fair value changes in the hedging derivatives' fixed and floating legs respectively.
10. In the above example the bank has issued 5-year variable rate funding paying 3m LIBOR coupons. It would be unusual for a bank to operate with fully committed funding for the entire period of its lending portfolio. Bank funding is more typically a mix of committed and rollover<sup>7</sup> funding. However, if revaluation movements for interest rate risk on the current committed funding are included within the revaluation adjustment, with no assumptions on future rollovers, this would provide some offset to fair value changes from the most recently fixed floating leg of hedging derivatives. This would better reflect the entity's economic position regarding its interest rate risk.

---

<sup>5</sup> Some variation might still be possible where fixing dates on the funding and derivatives are not fully aligned.

<sup>6</sup> As described in staff paper 4B at the September 2012 meeting.

<sup>7</sup> For example a portfolio of short term money market deposits or repos that are rolled into new deposits or repos on maturity attracting the prevailing market interest rate on issue.

## Impact on accounting for macro hedging from credit risk related changes in the fair value of derivatives

11. Banks manage interest rate risk and counterparty risk from derivatives separately. Distinct limit structures are in place based on risk appropriate methods and procedures for each risk type.
12. Risk management approaches to interest rate risk do not expressly consider the credit risk attached to a particular hedging strategy<sup>8</sup>. Confirmation will only be required that the proposed strategy will not result in a breach of existing counterparty credit limits before any instruments can be traded. Active management of on-going derivative counterparty credit risk will usually be undertaken separately by the credit function/desk.
13. Credit functions will also separately manage the credit risk that arises on items within the hedged portfolio that are measured at amortised cost. However, there is no expectation that credit risk on the hedging derivatives and the exposures those derivatives hedge will offset<sup>9</sup> and they are not typically managed as part of the same portfolio for credit risk. Furthermore, as the aim of the revaluation adjustment is to better reflect portfolio interest rate risk management activity, arguably changes in credit risk of the hedged portfolio should not be included in the revaluation adjustment for interest rate risk. Any revaluation adjustment is owing to changes in the hedged risk only, ie interest rate risk in this instance.

### Considerations under IAS 39

14. Under both the new hedge accounting model of IFRS 9 *Financial Instruments* as well as the existing fair value portfolio hedge accounting guidance in IAS 39 *Financial Instruments: Recognition and Measurement*, hedge ineffectiveness can arise from movements in the fair value of hedging instruments owing to changes in credit risk and floating legs within hedging derivatives.

---

<sup>8</sup> Although credit risk is a consideration when pricing hedging instruments (see also paragraph 3).

<sup>9</sup> Counterparties for the derivatives and hedged exposures are unlikely to be exactly the same, and such items have different sensitivities to credit risk.

15. Many preparers have raised concerns about hedge ineffectiveness resulting from changes in derivative credit risk and floating legs under IAS 39. However, this is partly because it is possible that changes in fair value owing to credit risk or floating legs can cause hedge accounting relationships to fail the bright-line effectiveness test in circumstances in which risk managers would still consider them effective for risk management purposes.
16. No bright-line effectiveness tests have been considered necessary or appropriate in the discussion to date on the accounting model for macro hedging. Therefore, although the revaluation adjustment will hardly provide a *full* offset in profit or loss to the changes in the hedging derivative's fair value (in particular because of the effect of credit risk and floating legs), such changes in fair value should not be decisive for the question whether the accounting model for macro hedging can be applied.

### **Conclusion**

17. Hedging derivatives should be measured at fair value in accordance with IFRS 13, which includes consideration of credit risk and any floating legs.
18. Reflecting on the Board discussions so far, the proposed revaluation model would be applied on a consistent basis over time instead of being started and discontinued by reference to a bright-line 'effectiveness test'. Therefore, profit or loss volatility from changes in the fair value of hedging derivatives owing to credit risk or floating legs should not preclude the application of the revaluation model where portfolio hedging activity is still undertaken.
19. Including floating rate instruments within the hedged portfolio that is subject to the revaluation adjustment would provide some offset to changes in fair value from hedging derivatives' floating legs. Such a treatment would also be consistent with the risk management approach for floating rate instruments and better represent the entity's economic situation regarding interest rate risk.