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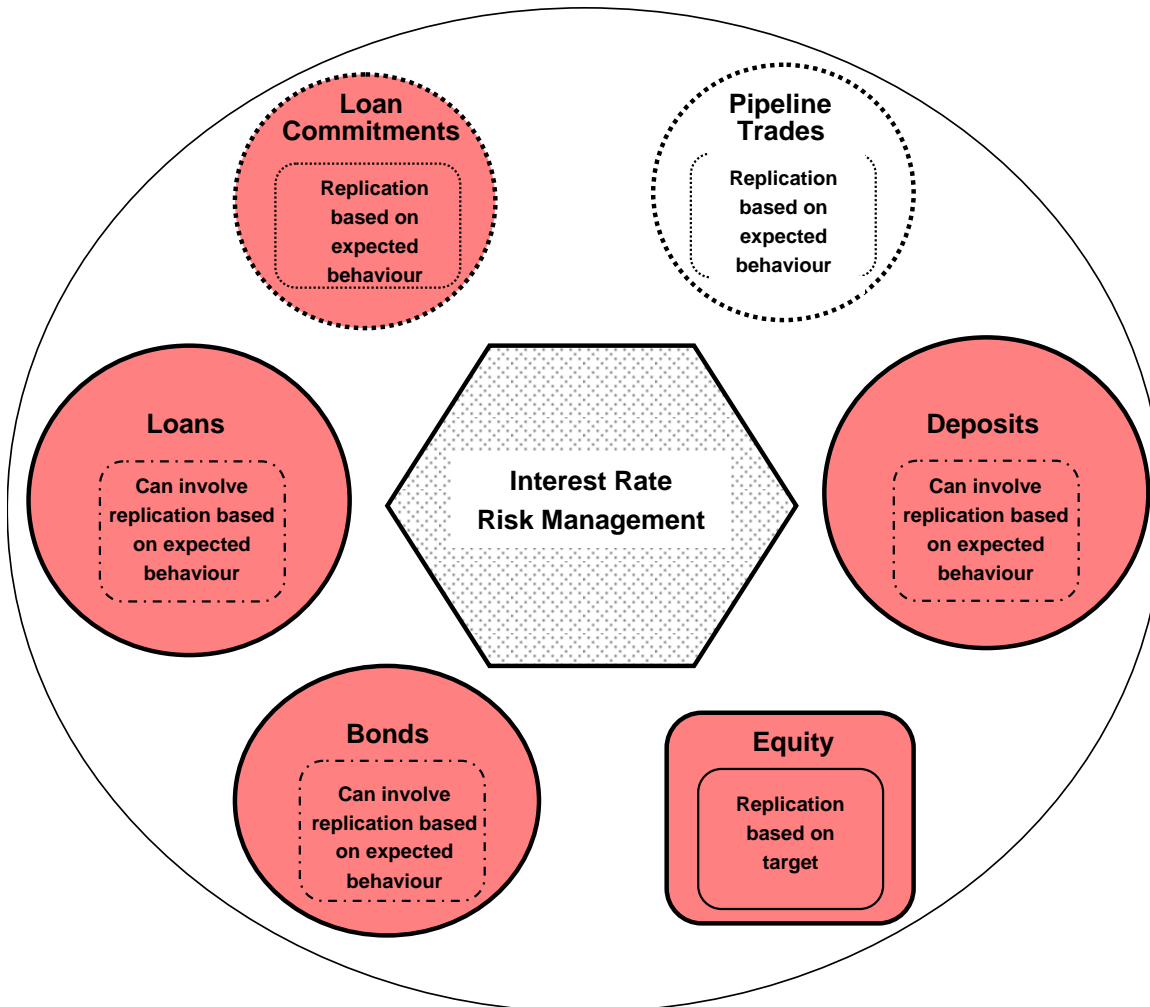
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Introduction

1. So far the detailed discussion of the “11 steps”¹ relating to hedged items has been limited to situations in which the hedged risk exposure resulted from *recognised* financial instruments (balance sheet items). Common risk management approaches however also consider interest rate risk resulting from transactions that:
 - (a) already exist but are not recognised for accounting purposes (eg many loan commitments); and
 - (b) are not yet executed, ie that do not yet exist (eg forecast issue volumes of products at advertised rates—colloquially referred to as ‘pipeline trades’).
2. This paper discusses how these two types of interest rate risk exposures could be integrated in the accounting model for macro hedging that the Board has discussed in this project (ie based on a net portfolio revaluation approach for interest rate risk). The focus of the discussion is whether these unrecognised items could be included in the hedged risk position and, if so, how that might be done.

¹ As first discussed at the November 2011 meeting, Agenda paper 7A.

3. The following diagram shows different types of interest rate risk exposures that are part of interest rate risk management:



Loan commitments

4. Loan commitments for the purpose of this paper refer to contractual obligations to grant a loan (or other interest-bearing financial instrument) at a fixed rate²:
- (a) with a corresponding *obligation* of the counterparty to borrow the money as agreed (ie a firm commitment, which is a **forward contract**);
- or*

² Loan commitments at a *variable* rate do not create the type of interest rate risk exposure that common interest rate risk management views associate with 'pipeline trades'; they are consequently outside the scope of this paper.

- (b) that are *dependent on the exercise* by the counterparty (ie a **written option** from the perspective of the potential lender).

Forward contracts

5. A loan commitment that is a forward contract can be designated as a hedged item in a fair value hedge because even though it is unrecognised in the balance sheet it is an *existing* item that gives rise to fair value interest rate risk. As for firm commitments that are designated as hedged items, applying hedge accounting would result in recognising the item and the fair value changes attributable to the hedged risk.
6. For these loan commitments interest rate risk in the form of fair value risk exists and its nature is the same as interest rate risk arising from recognised financial assets and liabilities. In that sense, there is no conceptual obstacle for applying the same accounting model for macro hedging as for recognised financial assets and liabilities. Therefore, there would be a sound rationale for including such loan commitments in the hedged risk position when accounting for macro hedging.
7. Regarding the presentation of the item in the balance sheet, the treatment should be consistent with that for a firm commitment in the general hedge accounting model. This means once recognised in the balance sheet, the loan commitment would be presented as a financial instrument.

Written options

8. Compared to loan commitments that are forward contracts, those that are written options have a risk profile that is more similar to recognised fixed rate financial instruments with optionality, such as prepayable loans. Accordingly, risk management approaches applied are similar:
- (a) Determine the expected cash flows on a portfolio basis dependent on expectations regarding the timing and volume of their exercise (ie portfolio replication based on expected behaviour of counterparties);
 - (b) Use interest rate options (swaptions) to address the optionality risk; or
 - (c) A combination of both approaches.

9. Again, loan commitments that are written options are *existing* items (contracts) even though they are often unrecognised in the balance sheet. Therefore, there would be a sound rationale for including such loan commitments in the hedged risk position when accounting for macro hedging.
10. Regarding the presentation of the item in the balance sheet: similar to loan commitments that are forward contracts, once recognised in the balance sheet, this type of loan commitment would be presented as a financial instrument.

Pipeline trades

Difference between pipeline trades and loan commitments

11. ‘Pipeline trades’ refer to situations in which financial instruments (eg mortgages) are publically offered for a period of time at fixed rates, ie even when interest rates are changing the terms of the offered products are not adjusted³. Therefore, from a risk management perspective the interest rate risk associated with pipeline trades is economically broadly similar to that described for loan commitments above. This is the case even though pipeline trades are *anticipated* future contracts instead of *existing* contracts. For example, loan commitments that are written options involve the uncertainty of acceptance by the counterparty. Similarly, for pipeline trades there is uncertainty as to how many (potential) customers will accept the bank’s product offer. Hence, common interest rate risk management approaches for pipeline trades are the same as those for loan commitments that are written options (see paragraph 8).
12. In summary the key difference between loan commitments and pipeline trades is that pipeline trades are transactions that do *not (yet) exist*. They are only anticipated—like a forecast transaction.

³ The reasons why the terms of the offered products are not adjusted are explained in paragraph 21.

13. The Basis for Conclusions of IAS 39 *Financial Instruments: Recognition and Measurement* sets out why forecast transactions are not eligible hedged items in a *fair value* hedge:⁴

The Board also noted that treating a hedge of a forecast transaction as a fair value hedge is not appropriate for the following reasons: (a) it would result in the recognition of an asset or liability before the entity has become a party to the contract; (b) amounts would be recognised in the balance sheet that do not meet the definitions of assets and liabilities in the Framework; and (c) transactions in which there is no fair value exposure would be treated as if there were a fair value exposure.

Could interest rate risk from pipeline trades be integrated into an accounting model for macro hedging?

14. So what does that mean for the question of whether and how an interest rate risk position from pipeline trades can be integrated into an accounting model for macro hedging?

Forecast transactions versus existing items

15. As for forecast transactions more generally, there is no conceptual basis for including pipeline trades, like existing items, in the hedged risk position in the accounting model for macro hedging. In other words, recognising pipeline trades in the balance sheet as financial instruments would be incompatible with the Conceptual Framework as well as IFRSs more generally.⁵
16. However, hedge accounting has a solution for hedges of forecast transactions even though they are anticipated instead of existing items. It is already the case that if a forecast transaction is highly probable it can be designated as the hedged item in a cash flow hedge. The cash flow hedge mechanics result in recognising the gain or loss on the *hedging instrument* (to the extent it is an effective hedge) in other comprehensive income (OCI) instead of profit or loss. These mechanics avoid

⁴ See IAS 39.BC148. The same considerations apply under the IASB's new hedge accounting model developed as part of the project on IFRS 9 *Financial Instruments*.

⁵ This follows from aspects (a) and (b) in the quote of IAS 39.BC148 above.

recognising the *hedged item* in the balance sheet and hence avoid the conflict with the Conceptual Framework and other IFRSs that would otherwise arise from recognising an item that does (yet) exist. This raises the question of the relevance of cash flow hedges to integrate pipeline trades into the accounting model for macro hedging.

Could cash flow hedge mechanics be applied?

17. The first question is whether cash flow hedge type accounting reflects actual risk management or not. As shown at the September 2012 meeting⁶, common interest rate risk management approaches in the banking sector are based on the Grid Point Sensitivity (GPS) type technique. That captures the *fair value* changes per a certain amount of benchmark interest rate changes in an integrated manner. This analysis would include pipeline trades. In that sense, the accounting view that disputes that there is fair value risk in pipeline trades differs from the risk management view in the banking sector, which deems there is fair value risk. However, the inconsistency in views by itself does not mean that the interest rate risk from pipeline trades cannot be integrated into an accounting model.
18. The second question is operational feasibility. The basic mechanics of a cash flow hedge are that the valuation is capped at the respective offsetting valuation of the hedging instruments so that no volatility (ineffectiveness) resulting from the forecast transaction is recognised.⁷ This concept works in the context of one-to-one relationships. But applying the idea of a cap for the valuation of pipeline trades is rather difficult for an accounting model for macro hedging that is based on a portfolio revaluation model. This is because pipeline trades represent only one element of the entire interest rate risk position. At any one time, there are many hedging instruments. Consequently, a one-to-one relationship between pipeline trades and a (or some) specific hedging instrument(s) in the GPS type risk management does not exist. Hence it would be hard or even impossible to identify the amount at which the valuation of pipeline trades should be capped.

⁶ See staff paper 4B of that meeting.

⁷ This is the outcome of the asymmetrical 'lower of' test for a cash flow hedge. It is designed to avoid that gains or losses are recognised for items that do not (yet) exist, ie gains or losses on the forecast transaction. Hence, recognition in OCI and profit or loss (for hedge ineffectiveness) is limited to the fair value change of the *hedging instrument*.

Can forecast transactions give rise to fair value risk?

19. Another possible solution is to present the revaluation of pipeline trades in OCI instead of as assets and liabilities, with changes in revaluation recognised in profit or loss. The advantage of this approach is that it can avoid the operational difficulty of applying the ‘cap’ like accounting mechanics used in a cash flow hedge. However, because no ‘cap’ is applied, the change in value of the pipeline trade could be higher than that of the derivatives used for hedging the interest rate risk. If and to the extent that such a difference exists⁸ it would give rise to conceptual concerns similar to those over the recognition of an asset or of a liability for an item that does not exist. This means that the concerns set out in (a) and (b) in paragraph 13 above, would in part remain.
20. Moreover, it has to be evaluated whether the third reason for the prohibition of the application of a fair value hedge, (c) in paragraph 13 above, applies or not. Does fair value risk exist in these forecast transactions?
21. The question here is why an entity that wants to stay ‘at market’ with financial transactions (eg mortgages) that are not yet contracted believes that it needs to hedge in order to stay ‘at market’ In other words, why does the entity not price the forecast transaction to the prevailing market conditions at the time it enters into the contract.
22. The staff understand that it is because entities do not wish to change the offered terms to reflect the latest market conditions before customers take up their offer. Because of logistical reasons combined with a concern over the loss of reputation, it is undesirable for entities to change the offered transaction conditions once they are advertised each time market rates change. This is the reason why the entity wants to hedge out interest rate risk in non-existing anticipated contracts. This discussion is similar to the issue of ‘economic compulsion’. The entity has no *obligation* that gives rise to an exposure but the reality is that it is in effect compelled to take the exposure. In other words, the entity reacts (by entering into derivatives) to a *likely course of action* that is not the result of an obligation but that nonetheless is realistically *hard to avoid because of commercial pressures*.

⁸ However, whether that was actually the case would be difficult to ascertain for the reasons set out in paragraph 18. In other words, it is a possibility but difficult to verify whether and to what extent it crystallises.

Economic compulsion is a notion that IFRSs conceptually do not consider an appropriate basis for changing accounting outcomes. Accounting areas that relate to economic compulsion are for example:⁹

- (a) the classification of financial instruments as debt or equity in accordance with IAS 32 *Financial Instruments: Presentation*; and
- (b) the recognition of non-financial liabilities in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

23. This shows integrating pipeline trades into the accounting model for macro hedging would require acceptance of *deemed* fair value interest rate risk in forecast transactions. In other words, it would have to be accepted that the existence of ‘economic compulsion’ for the entity *creates* interest rate risk in the form of fair value risk.
24. This analysis shows the accounting treatment shown in the paragraph 19 is difficult to accept, as (forecast) *transactions in which there is no fair value exposure that arises from existing obligations would be treated as if there were a fair value exposure*. The entity is not really exposed in the sense that from a legal perspective it could ‘walk away’ (because it is not yet contractually bound).
25. The prohibition of the application of fair value hedging for forecast transactions can also be understood as a way to avoid the recognition of ‘internally generated goodwill.’ For instance, suppose a bank advertises its mortgage products with a 10 year maturity at a contractual fixed rate at 5% when the corresponding benchmark market rate is at 4%, and the benchmark rate declines to 2% three days after the start of the advertisement with no application for the products by that day. In this case, if there is still an expectation that some customers will wish to enter into the product at the advertised rates, then the *deemed* fair value risk in these pipeline trades will result in a positive revaluation of the pipeline trades, leading to the recognition of a gain in profit or loss and a corresponding amount in OCI¹⁰

⁹ The Conceptual Framework includes some high level discussion that relates to economic compulsion in the context of the definition of a liability (see F.4.15–16).

¹⁰ When the market benchmark rate declines, a lower amount of drawdown is expected as the contractual mortgage rate (5%) is now less attractive for potential borrowers. This may mean the revaluation gain in the *replicated* portfolio of pipeline trades based on borrowers’ behaviour is less than any loss from hedging derivatives.

that could be regarded as similar to ‘internally generated goodwill’ (albeit not presented as an asset). The similarity to internally generated goodwill is that the future expected business of the entity would result in an economic gain because the entity would be able to achieve an additional margin from changes in interest rates. This economic gain does not relate to existing assets or liabilities but the entity’s future business opportunities, similar to having a customer base that creates business with a strong margin, which increases internally generated goodwill.¹¹

26. Therefore, it is difficult to find a conceptual basis for including pipeline trades in the hedged risk position in the accounting model for macro hedging.

Conclusion

27. From the perspective of interest rate risk management approaches in the banking sector, the interest rate risk that arises from unrecognised items such as loan commitments and pipeline trades is similar to that on recognised financial instruments. As long as these items are *existing* items (ie contracts), they can be included in the hedged risk position in an accounting model for macro hedging based on a revaluation model. This allows loan commitments to be integrated into the revaluation model.
28. In contrast, justifying the inclusion of pipeline trades in the hedged risk position would require conceptual concessions, ie accepting inconsistencies with the Conceptual Framework and IFRSs:
- (a) it can result in recognising gains or losses from forecast transactions (because it would not be operationally feasible to apply a ‘cap’ similarly to the ‘lower of’ test for cash flow hedges);
 - (b) accounting for *fair value* risk from forecast transactions implicitly means considering the effect of economic compulsion for accounting purposes; and

¹¹ Conversely, if the benchmark rate increases that would result in recognising amounts in OCI that could be considered as similar to ‘internally generated badwill’.

(c) it leads to the recognition of items that could be considered akin to ‘internally generated goodwill’.

29. However, this conceptual view has ramifications for the application of the revaluation model to other interest rate risk exposures (that can be revalued for interest rate risk without those conceptual concerns): not accepting the inclusion of pipeline trades in the hedged risk position in the accounting model for macro hedging could lead to accounting results that do not necessarily reflect actual risk management. For instance, if an entity is not able to include pipeline trades within a revaluation model, derivatives entered into for the purpose of hedging those pipeline trades would result in profit or loss volatility as there would be no offset to their fair value movements. Hence, a decision on whether to accept including pipeline trades into a revaluation model should take this aspect into account (ie creating the incentive for entities to optimise the accounting outcome by using alternative accounting solutions, which comes at the expense of increased complexity both in terms of understandability of the information as well as from an operational perspective).