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Project	**Accounting for macro hedging**
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Introduction

1. The solution discussed so far for the accounting for macro hedging has been the portfolio revaluation approach. Application of that approach would require the revaluation of dynamically risk managed portfolios with respect to the managed risk, without any change to the accounting for hedging instruments, which will be at fair value through profit or loss. Accordingly, the portfolio revaluation adjustment will be recognised in the balance sheet and profit or loss. An offsetting effect in profit or loss should be achieved from fair value changes of hedging instruments, to the extent offsetting risk positions exist.

2. At the May 2013 Board[1] meeting, the scope of application of the portfolio revaluation was considered. During the meeting, the benefit of the additional information the portfolio revaluation approach provides on dynamic risk management activities was acknowledged. However, some questions were raised about the application of the approach on a holistic[2] basis, specifically (in the context of interest rate risk management) whether revaluation volatility from

[1] May 2013 agenda paper 4B focuses on interest rate risk management in the banking sector, as it is a well known example with a need for an accounting model for macro hedging and it is the scenario that the Board has considered in most detail. However, it should be noted that the accounting for macro hedging is intended to be used to represent dynamic risk management for open portfolios for various types of risks by entities in financial as well as non-financial industries.

[2] Holistic application of the portfolio revaluation approach for the purposes of this paper means application of the approach wherever dynamic risk management for the identified risk is undertaken.

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unhedged positions provided useful information on the performance of the bank *if* it is presented in profit or loss. Although it provides 'complete' information about exposures, many preparers do not think it reflects dynamic risk management and are also concerned about the lack of comparability with those that choose not to undertake risk management.

3. This paper investigates the possibility of the holistic application of the portfolio revaluation approach **through OCI**, rather than through profit or loss. Specifically by recognising both the revaluation of risk managed portfolios with respect to the managed risk, and the fair value of hedging instruments in OCI rather than profit or loss. No change to the balance sheet (BS) treatment would be required.[3] As has been customary, while the Discussion Paper will propose that the revaluation approach could be applied to the dynamic management of a variety of risks this paper focuses on application in the context of a bank's interest rate risk management for the purposes of illustration.

4. This alternative approach using OCI is compatible with the 'actual net interest income' presentation as discussed by the Board in May 2013[4]. However, it would result in 'the revaluation effect from dynamic risk management' being recognised in OCI rather than profit or loss, as previously discussed. The accounting entries would be as follows:

	Managed exposures		
DR/CR[5]	Revaluation	BS	X+Y
CR/DR	Interest accrual	NII[6]	(X)
CR/DR	Clean revaluation	OCI	(Y)

[3] For particular exposures where it may not be acceptable to recognise the revaluation as an asset or liability in the statement of financial position (eg the equity model book and pipeline transactions), further difficulties may arise if both the DR and CR representing the revaluation of these exposures are recognised in OCI.

[4] See May 2013 Agenda paper 4A. Conversely, the portfolio revaluation approach through OCI would not be compatible with the 'stable net interest income presentation' as the profit or loss would always present a perfectly hedged position, which will not always be the case. There was however, limited support for the stable net interest income presentation when discussed in May 2013.

[5] The entry could either be a debit or a credit hence both are reflected.

[6] Net interest income recognised in profit or loss.

Hedging instruments

DR/CR	Fair value	BS	(A+B)
CR/DR	Net interest accrual	NII	A
CR/DR	Clean fair value	OCI	B

The net revaluation effect from dynamic risk management reflecting the extent of offset between managed exposures and risk management instruments with respect to the identified risk would be recognised in OCI[7]. Net interest income would present the net interest income achieved in the period after risk management. In the statement of financial position the full fair value of hedging instruments and the valuation of managed exposures would be recorded. Note as hedging derivatives and managed exposures move towards maturity, revaluation from dynamic risk management activities recognised in OCI would naturally tend to zero (ie over time the measurements would converge to the cash amounts so there would be a 'pull-to-par' effect) as interest related to realised cash flows is recognised in net interest income (NII).

5. A key consideration is whether such an approach enhances the usefulness of the information on how a bank has transformed NII in the current period, whilst maintaining the wider information on dynamic risk management activities relating to future NII that the holistic application of the portfolio revaluation approach provides.

6. However, even if this use of OCI is thought to provide useful information on dynamic risk management activities, there are additional factors to consider:

    i. Breaks a key assumption so far in the deliberations that the portfolio revaluation approach does not change the accounting for hedging instruments.

    ii. The suggested use of OCI is not just a change in the presentation line, the staff have identified a number of practical issues with this proposed application[8].

[7] (Y) + B

[8] See paragraphs 8-14 for further discussion

iii. The purpose of OCI is currently being considered as part of the Conceptual Framework Project[9]. Some thought will need to be applied as to whether this use of OCI could (or could not) be justified within the context of the Conceptual Framework Project.

iv. The staff recognise accounting choices by some preparers may also be influenced by the impact on relevant prudential regulation. Thus the prudential impact of recognising the revaluation effect from dynamic risk management activities in OCI would ordinarily be taken into account by prudential regulators and preparers.

7. Further discussion is provided below on both the practical (ii) and conceptual (iii) difficulties with the application of the portfolio revaluation approach through OCI.

Practical difficulties

Internal derivatives

8. At the September 2012 Board[10] meeting there was a discussion about whether 'internal derivatives[11]' representing the transfer of risk from ALM to the trading desk, could be 'grossed up' in profit or loss. It was thought such a treatment could provide useful information on the different activities of the two internal counterparties to the internal derivatives, ie dynamic risk management and trading activities. A key assumption in that discussion was that any gross up of internal derivatives would have no impact on **net** profit or loss[12]. However, if the revaluation effect from dynamic risk management activities was to be recognised

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[9] A Discussion Paper on the conceptual framework is due to be issued shortly. See paragraphs 15-28 in this paper for further discussion

[10] September 2012 agenda paper 4A

[11] Internal derivatives are derivatives that are entered into between different business units within a consolidated group. In this scenario, internal derivatives would ordinarily be between ALM (asset and liability management) and the Trading desk, reflecting the transfer of risk between those business units, without any change to the external risk position.

[12] IFRS 10 B86(c) requires that profits or losses from intragroup transactions are eliminated in full in the consolidated financial statements. One common exception to this guidance is the profit or loss from retranslation of foreign currency intra group monetary items which is recognised in profit or loss (IAS21.45).

in OCI[13] without any other change to the approach, then that key assumption would no longer be valid – as internal derivatives would indeed affect reported profit.

9. In the discussions to date, the Board has indicated that presentation of internal derivatives could indeed provide useful information. Therefore, we list below some possible 'solutions' to the issue of internal derivatives if the portfolio revaluation approach used OCI. These solutions would all require further analysis as they are not without related difficulties[14]:

    (a) Allow internal derivatives to be grossed up in the profit or loss and OCI on application of the revaluation approach through OCI, **but only if**:

        - Externalisation of internal derivatives by the trading desk can be proven; or
        - Certain parameters are met such that it can be proven that 'sufficient' risk is externalised; or
        - The level of externalisation is disclosed in the notes; or
        - There is confirmation that internal derivatives have not 'increased' risk in ALM; or
        - Profit or loss and OCI are presented as a single statement.

    (b) Don't include restrictions (so allow internal derivatives to affect profit or loss);

    (c) Do not allow internal derivatives to be grossed up in profit or loss and OCI on application of the revaluation approach through OCI. Only permit OCI treatment to be applied to external derivatives. This would mean that a subset of external derivatives in the trading book would need to be

[13] Internal derivatives from the trading desk's perspective would still be accounted for at fair value through profit or loss, whereas fair values of the related internal derivatives from ALM's perspective would be recognised in OCI. (See example in paragraph 4, where 'B' would include clean fair values from internal derivatives)

[14] The difficulties with reliance on externalisation by the trading desk were discussed by the Board in September 2012, agenda paper 4A

identified as relating to macro hedging activities, and derivatives in that subset would be remeasured[15] through OCI, unlike other derivatives.

Sale of managed exposure or close out of hedging instruments

10. When a managed exposure is sold or a hedging instrument is closed out, the carrying amount (including the revaluation adjustment) will be derecognised from the statement of financial position and included in the calculation of gain or loss on sale. However, if the revaluation effect from dynamic risk management activities is recognised in OCI, (including revaluation or fair value amounts to date for the derecognised instrument), there is no mechanism for it to subsequently be removed from OCI[16]. A recycling mechanism could be required to transfer the revaluation/fair value for derecognised items from OCI into the profit or loss either over time (amortisation), or at a single point in time. It should be noted that without a recycling mechanism part of the gain or loss on sale will never be recognised in profit or loss.

Non derivative hedging instruments

11. Non derivative instruments which are accounted for at fair value through profit or loss (FVTPL) may be included in the dynamic portfolio (either as exposures[17] or hedging instruments). If the revaluation effect from dynamic risk management activities is recognised in OCI, there is a question as to whether the *full* fair value change should go to OCI for non-derivative hedging instruments, or just fair value changes due to the managed risk?

12. For derivatives, it is commonplace to assume that all fair value changes are relevant for risk management. However, this may not be the case for non derivative instruments where risks that are not dynamically managed, such as credit risk, may be the main driver for fair value changes, at least in some periods. In that case it is difficult to argue that the location for recognition of *all* fair value

[15] As noted in agenda paper 4A from the September 2012 IASB meeting, unless the trading desk has fully externalised the risk transferred from ALM via the internal derivative, the revaluation effect from dynamic risk management calculated using external derivatives will not equate to the risk management activity.

[16] See discussion on the conceptual discussion with respect to recycling of OCI in paragraph 28

[17] Classification and measurement guidance in IFRS 9 may require FVTPL treatment, possibly due to the characteristics of the instrument, but for risk management purposes the instrument could be considered an exposure to be managed for interest rate risk.

changes, (including risks such as credit) should be changed where they do not form part of the dynamic interest rate risk management strategy. In a sense this would risk the revaluation approach overriding the classification model and not only in respect of the managed risk.

13. If it is not thought appropriate to change the location of recognition of fair value changes for risks other than the managed risk for non derivative hedging instruments, then there will be a need to isolate the fair value impact due solely to the managed risk. Such an approach would add operational complexity to the process, and the mechanism to isolate the managed risk element would need to be considered.

14. Even if suitable solutions can be identified for all the practical issues identified above, it is likely that the combination of solutions will significantly increase the operational complexity of the application of the portfolio revaluation approach through OCI.

Interactions with the Conceptual Framework Project

15. A critical question for the Board to consider is whether a proposal to recognise the revaluation effect from dynamic risk management activities in OCI is (or is not) consistent with the proposals on the purpose of OCI being developed as part of the Conceptual Framework Project. The purpose of the statement(s) of profit or loss and other comprehensive income, as suggested in the Conceptual Framework Discussion Paper, is to help users of financial statements to understand the *return* that an entity has produced on its economic resources. The Conceptual Framework project team has developed some principles (see below) for inclusion in the Discussion Paper, as a means to determine whether income and expense items should be recognised in profit or loss or OCI. The staff thought it would be helpful to contrast the application of these principles to the portfolio revaluation approach, both with recognition through profit or loss and through OCI.

    (a) *Principle 1*: Items of income and expense presented in profit or loss provide the primary source of information about the return an entity has made on its economic resources in a period.

(b) *Principle 2*: All items of income and expense should be recognised in profit or loss *unless* presenting an item in OCI enhances the relevance of profit or loss in that period.

Recognition of revaluation effect from dynamic risk management activities in profit or loss

16. It could be argued that the return an entity has made on its economic resources should reflect the effect of actions taken in the reporting period to address both current and future net interest income[18]. Therefore, **all** risk management activity (including decisions to hedge and *not* to hedge[19]) should be captured in the current period profit or loss.

17. Accordingly, the relevant profit or loss information for the period includes the net interest earned on the managed portfolio as well as the effects of the entity's dynamic risk management of the current and future net interest income. This is also consistent with the view that the full effect of derivatives, whether entered into for trading or risk management purposes, reflects the return generated from the use of the entity's economic resources in the period[20].

Recognition of revaluation effect from dynamic risk management activities in OCI

18. When items are measured at amortised cost in accordance with IFRS 9, this is because amortised cost is thought to provide the most useful information for users of financial statements in both the profit or loss and the statement of financial position. The key focus of banks' dynamic risk management is to transform net interest income from managed exposures using hedging instruments, which does not ordinarily change the entity's desire to collect the contractual cash flows. Therefore an alternative view on the *relevant return* could be that the primary

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[18] Note the customer margin (eg a lending margin and deposit margin) continues to be recognised on an accrual basis under the proposed portfolio revaluation approach.

[19] It could be argued that the decision **not to hedge** certain interest rate risk mismatches within a dynamically managed portfolio, is very different from a business model which is solely to collect cash flows from exposures **without regard** to interest rate mismatches. If one follows this view, revaluation profit or loss from risk management activities should be reflected in profit or loss to enable users of financial statements to differentiate between these different approaches to interest rate risk.

[20] This is consistent with the default requirement for derivatives to be accounted for at fair value through profit or loss. (IAS 39. 46-47 or IFRS 9 4.1.4 and 4.2.1)

focus should be on how net interest income in the period from exposures measured at amortised cost has been transformed by dynamic risk management activity. Consequently current period profit or loss should reflect the modified net interest income in the period (after risk management) from amortised cost exposures.

19. The revaluation effect from dynamic risk management activity provides information on the value of outstanding risk mismatches (after risk management) in **future** net interest income, so may not be considered relevant to the entity's return from resources in the current period[21]. Hence recognising the revaluation effect from dynamic risk management activities in OCI, enhances the relevance of reported net interest income in profit or loss, and provides relevant information consistent with the risk management view. However, by providing additional information related to the future net interest income overall, more comprehensive information is available to users of the financial statements – ie by combining the recognition in profit or loss with the information in OCI a richer information set is made available.

20. Furthermore, the revaluation effect from dynamic risk management activity is more usefully presented in OCI, as this reflects the fact that the rationale for maintaining residual interest rate risk open positions within an amortised cost portfolio is different from risk positions within the trading book, with the latter being included in profit or loss.

Considerations

21. In reality, the two views discussed above on whether the revaluation effect of dynamic risk management should be recognised in OCI or not, are not necessarily incompatible. For instance, if an entity *intentionally* leaves an open interest rate risk positions by *intentionally* not hedging an exposure, this decision has economically the same effect as an open trading position. At the same time, however, this activity could also easily be understood to be optimising net interest

[21] For instance, the Securities Analyst Association of Japan (SAAJ) states 'we consider that profit or loss is one of indicators that shows the recurring performance, while comprehensive income shows that performance together with risk profile of each entity' ('On the ASBJ's proposal on the presentation of comprehensive income,' February 2010).

income in future periods. Therefore perhaps there is no single answer as to which view or accounting alternative better reflects the economic truth.

22. However, even if the Board believes that recognition of revaluation effects from dynamic risk management in OCI could be justified in terms of enhancing the relevance of information provided on the return of an entity in a reporting period, some further considerations are relevant.

23. To enhance the understanding of the principles mentioned in paragraph 15 above, the Conceptual Framework Discussion Paper identifies groups of items that would be eligible for presentation in OCI, rather than profit or loss. The proposed eligible groups of items are as follows:

    (a) If the IASB adopts a narrower approach to OCI, only those remeasurements that are bridging items or mismatched remeasurements; or

    (b) If the IASB adopts a broader approach to OCI, only those remeasurements that are bridging items, mismatched remeasurements or transitory remeasurements.

24. The staff do not believe that this proposed use of OCI could be consistent with items of 'mismatched remeasurements' as described in the Conceptual Framework Discussion Paper. This is because it is expected that the application of the portfolio revaluation approach through profit or loss would *not* result in income or expense that provides an incomplete representation of a linked set of assets and liabilities. As described in the Conceptual Framework Discussion Paper, mismatched remeasurement only occurs when a remeasurement provides little relevant information about the return the entity has made on its economic resources in the period, which is not the case here.

25. However, further consideration would be necessary as to whether the use of OCI for the revaluation effect from dynamic risk management activity could be categorised as bridging items, transitory remeasurements, or both.

26. It might be reasonable to conclude the net revaluation effect could be a bridging item, as the relevant measurement in the statement of financial position for the net risk position is revaluation by managed risk/fair value, whereas the most relevant information in profit or loss is to reflect the transformed net interest income.

27. However, one might also determine that the use of OCI in the accounting for macro hedging meets the description of transitory remeasurements. For instance, the managed portfolio includes assets and/or liabilities which includes items that will be settled over *the long term*, for which the current period revaluation could significantly change over their holding period.

28. Further discussion will also be included in the Conceptual Framework Discussion Paper as to whether recycling from OCI is required or not. It should be noted that if the revaluation effect from dynamic risk management activity were recognised in OCI, it would ordinarily naturally transfer from OCI into profit or loss (ie NII) as part of the 'pull to par effect' for revaluations[22].

Comparison with IFRS 9 hedge accounting

29. If the revaluation effect from dynamic risk management activity is recognised in OCI, any volatility either from unhedged positions or imperfections in the dynamic hedging strategy for future net interest will be recognised in OCI and not current period profit or loss. In contrast, under the IFRS 9 hedge accounting requirements, profit or loss volatility arises from interest rate risk mismatches when the hedging strategy is imperfect.

30. Arguably because the macro model being investigated is not strictly speaking a form of hedge accounting the treatment need not be aligned. However, it should be noted that the portfolio revaluation approach will not provide discrete information in profit or loss about how effective the entity has been in hedging the risks it has set out to manage[23].

Overall summary

31. Perhaps it could be argued that the holistic application of the portfolio revaluation approach through OCI rather than profit or loss might still convey the same transparent information on risk management activity, but present it in a way that is more consistent with the risk management view. Thus, the staff suggest that this approach should be mentioned as an alternative in the Discussion Paper on Accounting for Macro Hedge Accounting.

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[22] An exception to this has been discussed in paragraph 12 of this agenda paper.

[23] The revaluation effect will include any imperfections in the hedging strategy, however this will be presented in combination with volatility from unhedged positions. See agenda paper 4B on disclosures.

32. However, as indicated in this paper, a number of new issues would arise and operational complexities may be introduced and in addition it gives rise to a number of questions about the consistency with the proposals from the Conceptual Framework Project. A combination of these factors and the need for banks to also consider the impact on regulatory capital, lead the staff to doubt whether this use of OCI is likely to form part of a suitable accounting solution for macro hedging activity.

Appendices

Practical example of the impact of applying the portfolio revaluation approach through OCI rather than profit or loss

Different presentation alternatives for the portfolio revaluation approach (through profit or loss) were discussed by the IASB in May 2013. Example 1 below is an extract from the agenda paper 4B, which included an example of the actual net interest income approach to profit or loss. Full details of the fact pattern are provided in the May 2013 agenda paper. We have then applied the portfolio revaluation approach through OCI to the same fact pattern and present the resultant profit or loss, under the actual net interest income approach in Example 2 below:

Example 1: Actual net interest income approach – portfolio revaluation approach through profit or loss

Profit or Loss	6m to 30-Jun-13	6m to 31-Dec-13	6m to 30-Jun-14	6m to 31-Dec-14
Interest revenue	2.0	2.0	2.0	2.0
Interest expense	(1.49)	(1.37)	(1.24)	(1.61)
Net interest from dynamic risk mgt	(0.01)	(0.10)	(0.21)	0.09
Net interest income	0.5	0.53	0.55	0.48
Revaluation effect from dynamic risk management	0.25	0.21	(0.67)	(0.52)
Total profit or loss for the 6 month period	0.75	0.74	(0.12)	(0.04)

Example 2: Actual net interest income approach – portfolio revaluation approach through OCI

Profit or Loss	6m to 30-Jun-13	6m to 31-Dec-13	6m to 30-Jun-14	6m to 31-Dec-14
Interest revenue	2.0	2.0	2.0	2.0
Interest expense	(1.49)	(1.37)	(1.24)	(1.61)
Net interest from dynamic risk mgt	(0.01)	(0.10)	(0.21)	0.09
Net interest income	0.5	0.53	0.55	0.48
Total profit or loss for the 6 month period	0.5	0.53	0.55	0.48

Other comprehensive income	6m to 30-Jun-13	6m to 31-Dec-13	6m to 30-Jun-14	6m to 31-Dec-14
Revaluation effect from dynamic risk management[24]	0.25	0.21	(0.67)	(0.52)
Total comprehensive income for the period	0.75	0.74	(0.12)	(0.04)

The same presentation for net interest income (and all gross interest lines) is achieved regardless whether the portfolio revaluation approach is applied through OCI or profit or loss. However, if the portfolio revaluation approach is applied through OCI, total profit or loss only reflects how dynamic risk management activity has impacted current period NII. The impact that existing dynamic risk management has had on future NII is not

[24] Revaluation profit or loss from dynamic risk management is the net of clean fair value of hedging instruments (possibly including internal derivatives) and the clean revaluation of managed external exposures

reflected in the profit or loss, that information is provided in other comprehensive income. Total comprehensive income is the same under both approaches.