

IFRS in Focus

IASB issues macro hedging discussion paper

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The Bottom Line

- The IASB has issued a discussion paper entitled *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*.
- The paper is the first due process document in the IASB's project to replace the macro interest rate fair value hedge accounting model in IAS 39.
- The 'revaluation approach' considered in the discussion paper is a simple concept of adjusting the measurement of the portfolio of exposures for changes in the hedged risk. The corresponding gain or loss is recorded in profit or loss to provide an offset against derivatives, measured at fair value through profit or loss, used to hedge those risks.
- Complexities arise from determining which exposures to include in the revaluation and how to measure the revaluation. For example, should any forecast transactions be recognised and measured on balance sheet? Should the whole portfolio exposed to the hedged risk be revalued or just the part that is hedged? Can only the bottom layer of a portfolio be remeasured?
- The IASB is seeking feedback to understand whether the model proposed would provide useful information and be operational.
- Although the discussion paper focusses on hedging interest rate risk, the IASB is particularly interested to use the paper as a basis for learning more about how the approach could be applied to other risks.
- The comment period ends on 17 October 2014.
- In a video podcast, Robert Bruce interviews Kush Patel, *Director in the UK IFRS Centre of Excellence*, on the Discussion Paper. Click [here](#) to access the video podcast of this interview.

Introduction

The IASB has issued a discussion paper entitled *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* ('the discussion paper'). This paper is relevant to companies that hedge risks on dynamic portfolios of exposures using derivatives (also referred to as "macro hedging"). Although the discussion paper focusses on the example of portfolio interest rate hedging by banks, the concepts discussed would be applied to any entity that hedges on a dynamic portfolio basis for any risks.

This form of hedging activity is complex and currently only accommodated to a limited extent in IAS 39 *Financial Instruments: Recognition and Measurement* which includes a macro fair value hedging model for interest rate risk. The IASB's objective is to consider an alternative macro hedging model that will ultimately replace the macro fair value model in IAS 39 and have wider applicability to other risks.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

The objective is to provide a model that will be less operationally burdensome than applying general hedge accounting to dynamic portfolios and be more reflective of an entity's dynamic risk management resulting in more meaningful and transparent financial reporting.

Although IFRS 9 *Financial Instruments* is a replacement of IAS 39, the IASB separated the macro hedging project from the IFRS 9 project to prevent delaying the completion of IFRS 9. Whilst the macro hedge accounting project is on-going adopters of IFRS 9 may, as an accounting policy choice, continue to apply the macro fair value hedge accounting model for interest rate risk in IAS 39.

What is the problem with macro fair value hedging under IAS 39?

When derivatives are used to hedge risks which are not measured on the same basis (i.e. fair value through profit or loss, FVTPL) volatility arises, despite the risk management objective of reducing economic volatility. Hedge accounting is available to reduce this volatility, however, hedge accounting is not well suited to the hedging of dynamic portfolios. The macro fair value hedging model in IAS 39 which makes some concessions to one-to-one hedging is designed to approximate one-to-one hedging and is not reflective of dynamic risk management.

Hedge accounting requires the specific designation of hedged items and hedging instruments and requires specific mechanics and effectiveness testing to be performed. Such requirements are better suited to individual hedges or hedges of static groups of items (or 'closed portfolios'), rather than hedges of portfolios of items that are constantly changing with new exposures added and old exposures removed (i.e. 'open' or 'dynamic' portfolios) and where the portfolio of hedging derivatives is also frequently changing.

Applying the general hedge accounting model to dynamic portfolio hedges gives rise to various issues, such as:

- Treating open portfolio hedges as a series of closed portfolio hedges inevitably leads to profit or loss volatility from hedge ineffectiveness that is inconsistent with the economic position and not reflective of the dynamic risk management applied.
- As the portfolio of hedged items and hedging instruments change, hedge accounting leads to frequent de-designations and re-designations which give rise to operational difficulties regarding tracking and amortisation of hedge adjustments.
- Hedge accounting requires the selection of either fair value or cash flow hedge accounting whereas neither in isolation directly portray the actual dynamic risk management activity of net margin hedging which is often the objective of dynamic portfolio hedging (e.g. net interest income hedging by banks).
- The hedge accounting model has restrictions on the exposures eligible for hedge accounting which can often exclude exposures that are economically hedged on a portfolio basis based on their expected term rather than their contractual term (e.g. demand deposits and pipeline transactions are not eligible for hedge accounting, see below).

What is the revaluation approach and how does it address the issues with hedge accounting?

The revaluation approach is different to hedge accounting and the basic idea and mechanics of the approach are relatively simple. Consider a bank that has portfolios of financial assets (e.g. loans) and liabilities (e.g. customer deposits) and hedges the resulting interest rate risk position between those assets and liabilities using interest rate swaps. The revaluation approach would result in the managed portfolio being remeasured for interest rate risk (with no assessment of hedge effectiveness required). The derivatives used for hedging the interest rate risk would, as normal, be accounted for at FVTPL. The net impact in profit or loss shows the bank's remaining open risk position, after hedging with respect to interest rate risk. The revaluation model would be an overlay adjustment to the normal accounting under IFRS 9. Hence the usual recognition and measurement of assets and liabilities would be applied first before a revaluation adjustment is applied.

The model is not a full fair value model, i.e. the risk exposures are only revalued for changes in the hedged interest rate risk and not for other risks such as credit risk. Therefore the normal accounting of income and expenses applies for the effect of other risks, for example the accrual of the credit margin charged on customer loans would be accrued in interest income as usual.

A portfolio revaluation model would address many of the accounting issues encountered with hedge accounting. For example, since the model applies to everything that is managed for interest rate risk, for the whole of its life, there are no complications with specific designations (or de- and re-designations). Also the burden of tracking and amortising hedge adjustments is reduced. Everything that is hedged for interest rate risk is continually revalued for interest rate risk.

The single model could also, if appropriately developed, represent an alternative for presenting hedging activities in the financial statements in addition to already existing fair value and cash flow hedging, resulting in a more faithful reflection of portfolio risk management activities.

A consequence of the basic model is that the larger the open position, the greater the volatility that is presented – even if the entity intentionally has not hedged the whole portfolio. As an alternative, the discussion paper considers narrowing the application to subsets of the overall portfolio (e.g. to discrete sub-portfolios, proportions of portfolios, bottom layer portions, portfolios based on risk limits, etc). These alternatives introduce operational complexities compared to the whole-portfolio revaluation approach and also impact transparency of the model which is discussed further below.

Observation

Applying the revaluation model to the whole portfolio could result in more profit or loss volatility than applying the general hedge accounting model for selected hedge designations. That is because the objective of the revaluation model is not solely to reduce profit or loss volatility, but is to provide more transparent and meaningful information about an entity's dynamic risk management, including information about any residual open positions in the hedged risk. For some, this may not be an acceptable consequence of addressing the accounting issues encountered with hedge accounting.

A key feature of the portfolio revaluation model is that the portfolio is the unit of account, hence the portfolio can be remeasured on a behavioural basis taking into account expected cash flows. This opens the door to the model potentially accommodating exposures that are currently ineligible under the general hedge accounting model. For example, demand deposits and pipeline transactions could potentially be eligible under this model since the portfolio would be measured on an expected cash flow basis which is more feasible and meaningful at the portfolio level. This would be more consistent with a risk management viewpoint.

The mechanics of the model are straightforward in that the hedged exposures are revalued based on present values where the expected cash flows of the portfolio are discounted by the hedged rate. Both expected cash flows of the portfolio and the discount rate are updated for changes which gives rise to a gain or loss recognised in profit or loss (i.e. the revaluation adjustment). Although simple in concept, this comes with various challenges which are considered further below.

The discussion paper also considers the financial statement presentation of such a model as well as disclosures that would accompany such a model.

Areas for discussion and feedback

Scope

The discussion paper considers what portfolios should be revalued and whether they should include all exposures that are dynamically managed together for interest rate risk or whether the application should be more focussed on discrete portfolios or proportions of portfolios that are hedged or managed by a bank.

The paper considers the pros and cons of broader versus narrower application. It considers that application to all exposures that are included in dynamic risk management would provide a complete picture of the residual interest rate risk position after considering all risk management activities. Although it notes that for those more interested in actual hedging activity, information on the whole portfolio included within dynamic risk management may not provide useful information. Another possible drawback of application to the whole portfolio is the cost required to adopt the whole-portfolio revaluation system for an entity that has limited fixed rate exposures.

The paper considers two possible ways of focussing on hedging activity rather than on the whole portfolio. It considers a sub-portfolio approach (e.g. only revaluing the mortgage portfolio for interest rate risk and leaving other portfolios, such as the corporate lending portfolio and issued bond portfolio outside of the model). It also considers a proportional approach, where the model is applied to a proportion, say 70 per cent, of the managed portfolio.

It notes that a focus on hedging activity would be more consistent with a hedge accounting model and allow banks to choose the optimal accounting solution to reduce profit or loss volatility. However, it also highlights that such an approach would not provide information about the effects of decisions not to hedge and also result in piecemeal application which may not be aligned with risk management. Restricting the model to accommodate hedging activity would also introduce some of the practical difficulties faced with hedge accounting around stopping and starting the revaluation model, for example when the 'hedged' proportion or the 'hedged' sub-portfolio changes.

Optional or mandatory?

The discussion paper acknowledges that if a free choice were given, an entity could choose between:

- Not applying hedge accounting or the portfolio revaluation model.
- Applying hedge accounting.
- Applying the portfolio revaluation approach for the whole portfolio.

Also, if the portfolio approach was developed to apply to sub-portfolios, entities would have the choice to mix and match and apply hedge accounting for some sub-portfolios and a revaluation approach for others. Such an approach would suit those focussed on reducing profit or loss volatility from hedging activities.

If there is optionality over applying the revaluation approach a further consideration would be whether it could be voluntarily discontinued and how the amortisation and tracking of past revaluation adjustments would be treated.

What items are included in the portfolio that is revalued?

The paper considers the inclusion of exposures based on expected cash flows, i.e. on a behavioural basis, instead of a purely contractual basis. This would mean that if a core level of demand deposits were included in the portfolio, they would be included on the basis of an expectation that deposits that could be immediately demanded are not expected to be demanded which would give rise to fair value interest rate risk. Also, where prepayable loans are included they would be based on the expected cash flow profile after considering prepayment expectations. Based on this approach the paper also considers if pipeline transactions and the equity model book should be included in the revalued portfolio or not.

Core demand deposits refers to the amount of a bank's portfolio of deposits that is expected to remain stable over a set period of time. The overall deposit base may fluctuate and deposits from one customer may be replaced by deposits from another customer, however, based on analysed behaviours, banks can often predict with some reliability a core amount of deposits that will be retained over set periods of time. Given the term of the core demand deposit base is modelled to be longer than the contractual term of each individual deposit (which is on-demand), core demand deposits give rise to fair value risk that is not available for fair value hedge accounting under the general hedge accounting model.

Pipeline transactions are forecast volumes of drawdowns on fixed rate products at advertised rates. These transactions are not yet firm commitments as the advertised rates could be withdrawn or refused, however in practice, for business development and reputational reasons, such offers remain for customers even if interest rates subsequently change unfavourably for the bank. As a result an amount of such exposures are hedged based on estimated volumes and effectively hedged as if they were firm commitments. It should be noted that these are not eligible for general hedge accounting.

Equity model book refers to a portion of a bank's equity that is targeted to have a fixed rate of return for its holders and is hence seen from a risk management perspective as giving rise to fixed interest exposure similar to an entity that instead of being equity funded is debt funded with fixed rate liabilities. The equity model book arises because a bank views its payments to equity holders as consisting of a fixed base amount to compensate them for the provision of funding (in a similar way to debt providers) plus a variable residual amount (resulting from total net income less the base return) to compensate them for the additional equity risk that they take on (i.e. they provide loss absorption). Although the base fixed return to the equity holders is not contractual, it is hedged based on the expectation that it will be paid. Hence from an interest rate risk management perspective the equity model book is not seen as any different to a fixed rate liability. As a result, this exposure is introduced into the portfolio managed for interest rate risk using a replication portfolio, for example the replication portfolio could be represented by a series of three-year fixed rate deposits. Managing the risk in this way allows a bank to protect the targeted base return to equity holders from interest rate risk.

The discussion paper highlights that in their discussions, the IASB noted that although applying the revaluation approach to pipeline transactions and the equity model book would bring risk management closer to accounting, this would raise issues that come with significant conceptual difficulties, on which no decisions have been made and would need careful consideration. Significant challenges would need to be overcome before complete alignment between risk management activities and accounting could be achieved. In addition, the IASB noted that whether such a complete alignment was achievable or desirable was also open to debate and discussion.

Revaluation of exposures

The revaluation of exposures with regard to the managed risk is calculated using normal present valuation techniques where the cash flows to be discounted (the numerator) and the discount rates (the denominator) are identified with reference to the *managed risk* (e.g. 3-month LIBOR).

The paper notes that when the risk management objective is to hedge net interest income, it is possible that the best representation of the managed risk is the benchmark funding index of the bank. However, to make the model more operational the transfer pricing mechanisms used within banks to transfer risk and internal funding to business units from Asset Liability Management (ALM) could be used to capture the relevant managed risk. This could make it easier to identify the cash flows to be discounted and the discount rates to be applied. For example, transfer pricing could be used to measure the core demand deposit. The implicit or deemed fixed interest rate risk in this is typically included in ALM via a series of transfer pricing deposit deals which could readily be used to measure the identified core element of the portfolio.

In practice the extent of use, controls around and robustness of transfer pricing information will vary. However, where the information is reliably determined it can represent an effective and practical approach for identifying and measuring expected cash flows. Although given variations in how transfer pricing is determined at different banks (discussed in more detail in the discussion paper) its use may pose challenges around comparability amongst banks. For example, banks may have different adjustments due to differences in own credit risk and pricing policies (e.g. providing a reduction in funding rates to incentivise a growth in certain loan products).

An additional consideration is the extent to which the risk *transferred* to ALM via transfer pricing is representative of the risk that exists in the managed exposure. For example, if the managed exposure is composed of sub-LIBOR instruments but the managed risk transferred to ALM using transfer pricing is LIBOR, then the question arises as to whether the transfer price of LIBOR could be used for revaluation of the sub-LIBOR exposure. The discussion paper specifically asks for feedback on whether sub-benchmark instruments should be included within the revaluation portfolio as benchmark instruments if this is consistent with the risk management approach.

Presentation

When it comes to presentation of the revaluation approach, the discussion paper considers three alternatives for presenting the adjustment in the statement of financial position and two alternatives for the presentation in the income statement.

The three alternatives considered for the statement of financial position are:

- **line by line gross up** – each asset and liability line item containing the exposures included within the revalued portfolio is adjusted to reflect the revaluation for the managed risk;
- **separate lines for aggregate adjustments to assets and liabilities** – separate new line items are used for revaluation adjustments for revalued assets and revalued liabilities; and
- **single net line item** – the net revaluation adjustment for all exposures subject to the portfolio revaluation approach is recorded in a new single line item in the statement of financial position within assets or liabilities depending on the net adjustment.

The two alternatives for the income statement are:

- **actual net interest approach** – actual interest income and expense is reported as normal but with an additional interest line to present net interest from risk management instruments (i.e. the net interest accrual on derivatives in the period); and
- **stable net interest income approach** – net interest income is reported on the assumption that a bank's risk management objective is to stabilise net interest. Interest income and expense is measured at the managed rate (plus any margins), which assumes the strategy has been fully effective.

Under each approach the residual portfolio revaluation adjustment (after taking into account amounts recognised within net interest income) would be presented as a separate line item.

Role of internal derivatives

The presentation of the revaluation approach is complicated when internal derivatives are used as risk management instruments rather than external derivatives. For example, where internal derivatives are used to transfer risk to a trading unit which selectively enters into external derivatives depending on its other offsetting positions and trading strategy. Furthermore, where external derivatives are entered into, they would not necessarily be on a basis to match the internal derivatives.

In order to separately reflect the risk management and the trading activity in the financial statements, the discussion paper considers the grossing up of offsetting internal derivatives in the income statement. The profit or loss from all internal derivatives would still be eliminated so there would be no net impact on profit or loss (i.e. the risk management and the trading unit internal derivatives would fully offset). However, the impact of internal derivatives would be shown gross in the income statement using the presentation discussed above for the revaluation portfolio with the 'other side' in trading profit or loss.

For example, consider an entity that has transacted an internal interest rate swap with its trading desk for dynamic interest rate risk management purposes. The trading desk has chosen not to enter into an equal and opposite external derivative because it wants to retain the risk. Assume the entity applies the actual net interest approach in the income statement as described above. On the trade date, the internal interest rate swap is on-market and has nil fair value. At the end of the period the swap's fair value has increased to CU110 of which CU100 represents the clean (i.e. excluding accrued interest) value. There are no interest settlements on the swap in the period (i.e. the interest accrual on the swap for the period is CU10). To demonstrate the effect of the dynamic risk management activities undertaken using internal derivatives the following entries would be included in the income statement:

Line item	CU
Interest income	X
Interest expense	X
Net interest from dynamic risk management	10
Net interest income	X
Revaluation effect from dynamic risk management	100
Trading profit or loss	(110)
Net profit or loss	X

As can be seen, although the gains and losses on the internal derivative are shown gross, the net impact in profit or loss is nil.

Disclosures

The discussion paper seeks input from users and preparers on disclosures that would enhance the user's understanding of an entity's dynamic risk management activity and how the revaluation approach has been applied in the financial statements. To facilitate this, the discussion paper considers four disclosure themes for consideration:

- Qualitative information on the objective and policies for dynamic risk management, including the identification of risks within exposures.
- Qualitative and quantitative information on the risk position(s) and its impact on application of the portfolio revaluation approach.
- Application of the portfolio revaluation approach.
- Quantitative and qualitative information on the impact of dynamic risk management on the current and future performance of an entity.

Alternative approach

The discussion paper considers a variation of the model described above whereby the net revaluation effect from revaluing the managed exposure and the changes in the fair value of the risk management instruments are recognised in other comprehensive income rather than profit or loss. The presentation of net interest income would be as set out above in the actual interest approach. The discussion paper notes that such an alternative has important practical and conceptual issues to be considered. For example, this alternative is inconsistent the underlying assumption in the development of the revaluation approach that the revaluation of risk management instruments would be recognised in profit or loss. In addition, the treatment of internal derivatives described above would need to be reconsidered since the gross presentation of internal derivatives would no longer net to zero in profit or loss.

Application to other risks

The IASB is aware that dynamic risk management activities exist outside of banking and in risks other than interest rate risk, such as foreign currency risk and commodity price risk. Hence the IASB is exploring developing an accounting approach for dynamic risk management activities that could be applied outside of interest rate risk. In the discussion paper, the IASB notes both similarities and differences between banks' dynamic risk management of interest rate risk to achieve stable net margins and dynamic risk management of foreign currency and commodity price risk in other industries. A number of challenges are noted, for example, the fact that forecast transactions are often hedged by corporates which would not give rise to any revaluation risk. Also, unhedged positions can be more significant as corporates tend to have hedging strategies where the hedged amount diminishes for exposures further into the future (e.g. they may hedge 100 percent for the first 12 months, 70 per cent for the next 12 months and 40 per cent of exposures thereafter), hence the revaluation approach could possibly give rise to more volatility than not applying hedge accounting.

Next steps

Comments on the paper can be submitted to the IASB until 17 October 2014. Following the close of the comment period the IASB will consider comments received to determine the appropriate next steps.

Further resources

Robert Bruce hosts a video podcast interview on the Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*. In the interview, Robert Bruce talks to Kush Patel, *Director in the UK IFRS Centre of Excellence*. Click [here](#) to access the video podcast of this interview.

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