MACRO HEDGING MADE POSSIBLE

The International Accounting Standards Board has published amended proposals in an Exposure Draft for IAS 39, *Financial instruments: recognition and measurement,* to enable fair-value hedge accounting to be used more readily for a portfolio hedge of interest rate risk, otherwise known as macro hedging.

The use of financial instruments for both risk management and other operating purposes is increasingly prevalent. At the end of 2002, the Bank for International Settlements estimated that the total notional amount of over-the-counter (OTC) derivatives contracts stood at $141.7 trillion, and the gross market values of those contracts was $6.4 trillion.

The IASB has been holding discussions, mostly with banks, to find a way within the principles of IAS 39 to accommodate macro hedging and, as a result, the IASB will permit it. The IASB says its aim was to develop an approach that:

- Complied with the principles that underlie IAS 39; and
- Was workable in practice for entities that manage interest rate risk on a portfolio basis.

The IASB decided to limit any amendments to applying fair-value hedge accounting to a hedge of interest rate risk on a portfolio of items.

The Exposure Draft (ED) proposes the following:

- In a fair-value hedge of the interest rate risk associated with a portion of a portfolio of financial assets (or financial liabilities), the hedged item may be designated in terms of an amount of assets (or liabilities) in an expected maturity time period rather than as individual assets or liabilities or the overall net position. It also proposes that the entity may hedge a portion of the interest rate risk associated with this designated amount.
- It proposes that all of the assets (or liabilities) from which the hedged amount is drawn must be items that could have qualified for fair-value hedge accounting if they had been designated individually. In the case of financial liabilities included in the balance sheet that a counterparty can redeem on demand (ie, demand deposits and some time deposits), the IASB concluded that the fair value of such liabilities is not less than the amount payable on demand and do not change with changes in the interest rate. Including such liabilities (ie, demand deposits and some time deposits) in a fair-value hedge would imply that its fair value changes with interest rates, which is inconsistent with the IASB's decision.

It follows that a financial liability that the counterparty can redeem on demand cannot qualify for fair-value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment.

- The amount of the assets (or liabilities) designated as the hedged item in a maturity time period determines the percentage measure that is used to evaluate hedge effectiveness. Any ineffectiveness is recognised in the profit and loss account.

For qualifying fair-value hedges, the adjustment arising due to the gain or loss attributable to the hedged item due to a change in the hedged risk may be presented in the following manner:

- In a separate line item within assets, if the hedged item for a particular maturity time period is an asset; or
- In a separate line item within liabilities, if the hedged item for a particular maturity time period is a liability.

The separate line items referred to above are to be presented in the financial statements next to financial assets or liabilities. Amounts contained in these line items will be removed from the balance sheet when the assets or liabilities to which they relate are derecognised.

Principles underlying ED's hedge accounting requirements

Hedge accounting allows entities to depart selectively from the normal accounting treatment that would otherwise be applied to the items included in the hedging relationship. In particular, cash-flow hedge accounting provides an exception by deferring the recognition in the income statement of derivative gains and losses, whereas fair-value hedge accounting provides an exception by accelerating the recognition of gains and losses on the hedged item. Hence, special principles are needed to provide discipline over the use of hedge accounting. Without such principles, the exceptions noted above would permit a free choice over when to recognise gains and losses. These hedge accounting principles fall into two groups:

- Those that underlie the ED's conditions for when a hedging relationship qualifies for hedge accounting (paragraph 3 of ED).
- Those that underlie the ED's requirements for the accounting treatment of a qualifying hedging relationship (paragraph 4 of ED).

A hedging relationship should qualify for hedge accounting only when the hedging relationship is:

- Clearly defined by designation and documentation
- Reliably measurable
- Actually effective

As regards the accounting treatment of a qualifying hedging relationship:

- To the extent that a hedging relationship is not effective, the ineffectiveness is recognised in the income statement.
- To the extent that a hedging relationship is effective, the offsetting gains and losses on the hedging instrument and the hedged item are recognised in the income statement at the same time.
- Only items that meet the definitions of assets and liabilities are recognised as such in the balance sheet.

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Useful links

- **The text of the ED *Fair-Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* is available from the IASB website at www.iasb.org.uk**