Hedge Accounting Masterclass

11 September 2023

Building a better working world

Agenda

1. What is it and why is it important?
2. The basics
3. Accounting models
4. Hedging strategies in a volatile interest rate environment

With you today

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01 Hedge Accounting: What is it and why is it important ?

Hedge Accounting – What is it?

What is hedge accounting?

- It is the application of special rules to account for a hedging relationship that can only be applied when the hedge accounting requirements are met
- It involves recognising gains and losses on a hedging instrument in the same period(s) and/or in the same line item in the financial statements as gains or losses on the hedged position/item
- This is a matching concept that eliminates or reduces the volatility in the P&L that otherwise would arise if the hedged item and the hedging instrument were accounted for separately under IFRS

Accounting policy context

- IFRS 9 provides entities with an accounting policy choice of either continuing to apply the hedge accounting requirements of IAS 39, or apply the IFRS 9 hedge accounting requirements (with the scope exception for fair value macro hedges of interest rate risk)
- As permitted under IFRS 9, an entity can apply IFRS 9 to all its hedges except for portfolio fair value hedges of interest rate risk (macro fair value hedge), where IAS 39 will be applied
- Most banks continue apply IAS 39 hedged accounting
- There is a project at the IASB to replace the current portfolio fair value hedge rules in IAS 39. The Dynamic Risk Management project is expected to publish and exposure draft in 2025

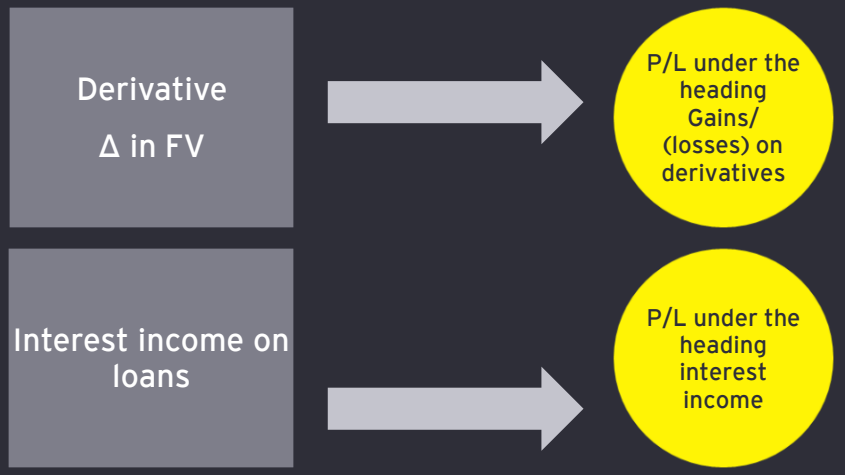
Hedge Accounting – Why it is important?

What is the problem?

Default Accounting

- Derivatives are always accounted for on balance sheet at fair value with changes being recognised in P&L
- This can create an 'accounting mismatch' as the hedged item is not held at fair value with changes through the P/L. For example, a portfolio of fixed rate loans will be held at amortised cost. As a result of the mismatch, presentation reflects

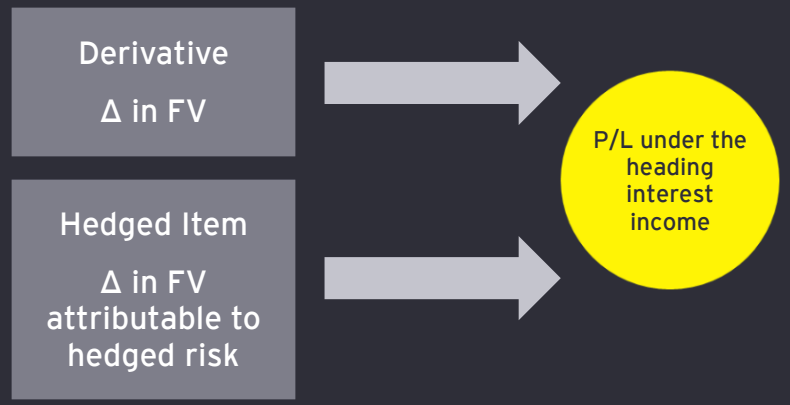
  – (1) volatile net income (2) line item mismatch:



What hedge accounting solves?

Hedge Accounting

- Hedge accounting modifies the normal accounting for either the hedging instrument or the hedged item to minimise the mismatch arising
- Recognising gains and losses on a hedging instrument in the same period(s) and/or in the same place in the financial statements as gains or losses on the hedged position



Note:
- The diagram above reflects the fair value hedge accounting model

02 Hedge Accounting: The Basics

Hedge accounting criteria

Qualifying criteria for hedge accounting

- A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:
  - The hedging relationship consists only of eligible hedging instruments and eligible hedged items
    - Only contracts with an external counterparty to the reporting entity may be designated as hedging instruments.
  - At the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective for undertaking the hedge
- The hedging relationship meets all of the hedge effectiveness requirements

Eligible hedged item and hedging instruments

- A hedged item can be a recognised asset or liability, a forecast transaction or net investment in a foreign subsidiary. It can be one or a group of items
- Derivatives can be designated as hedging instruments

Hedge documentation

Documentation of

- Risk management strategy and objective
- Hedged item, hedging instrument and risk hedged
- Hedge effectiveness ((including sources of ineffectiveness and how the hedge ratio is determined)*

* Under IAS 39, the sources of hedge ineffectiveness and hedge ratio are not required to be part of the hedge document

Hedge effectiveness

IFRS 9 hedge effectiveness requirements

- Economic relationship exists
- Credit risk does not dominate value changes
- Designated hedge ratio is consistent with risk management strategy

IAS 39 hedge effectiveness requirements

- Both prospective and retrospective assessment is required
- The effectiveness results should be between 80%–125%

Understanding of hedge accounting models

There are three hedge accounting models:

Fair value hedge (FVH)	Cash flow hedge (CFH)	Net investment hedge (NIH)
▸ Hedge of exposure to changes in the fair value that is attributable to a particular risk and could affect P/L	▸ Hedge of the exposure to changes in the cash flows that is attributable to a particular risk associated and could affect P/L	▸ Hedge of the foreign exchange movements on a net investment in a foreign operation

Micro hedge	Macro hedge
▸ Hedge of a single asset or liability	▸ Hedge of a portfolio of assets or liabilities with similar risk characteristics

Common hedging strategies

The below table summarises the common hedging strategies we see and which of the hedge accounting models they typically fall under.

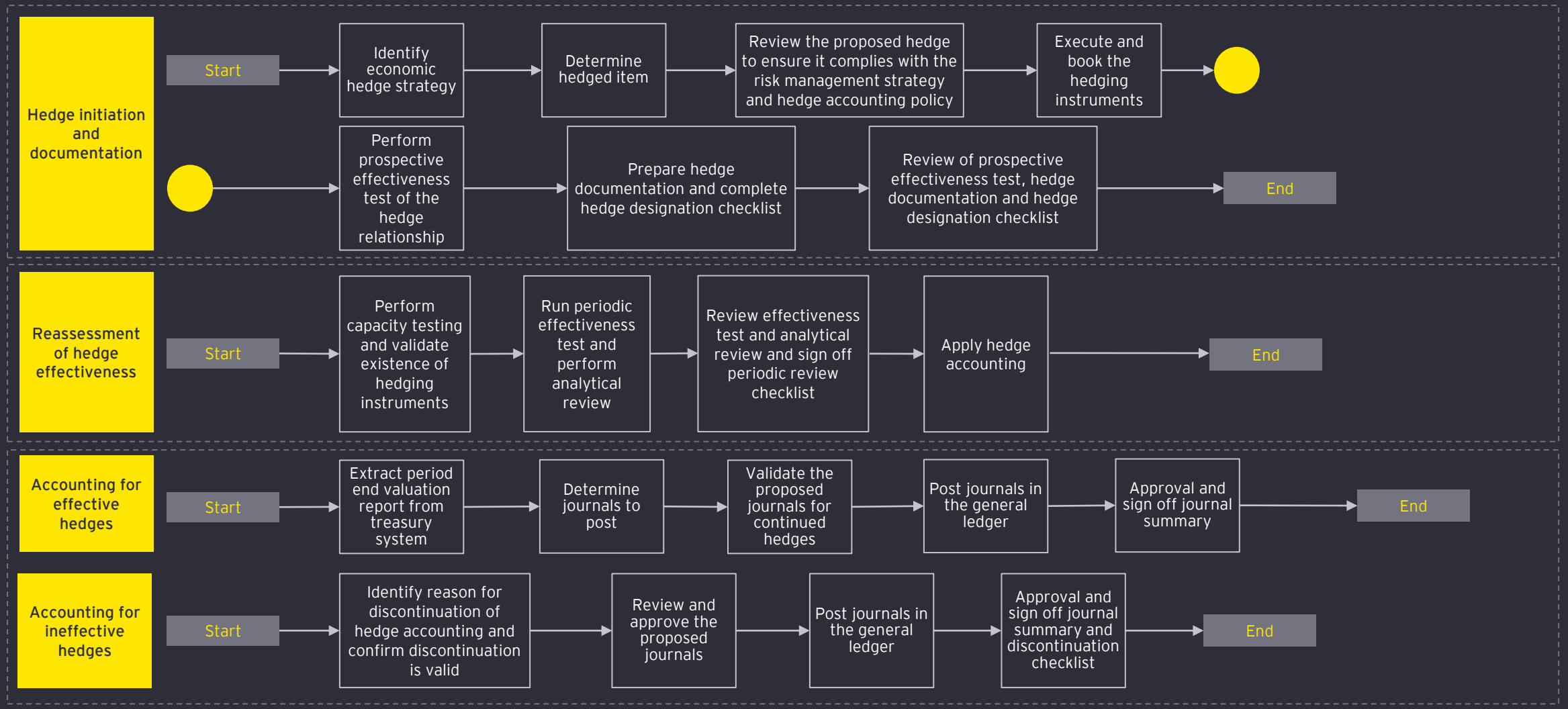
	Cash flow hedge (CFH)		Fair value hedge (FVH)		Net investment hedge (NIH)	
Hedged risk	**Hedged item**	**Hedging instruments**	**Hedged item**	**Hedging instruments**	**Hedged item**	**Hedging instruments**
Interest rate risk	▸ Loans to banks and customers (Variable rate assets) ▸ Banks and customer deposits (Variable rate liabilities) ▸ Cash at central bank	▸ Interest rate swaps	▸ Fixed rate loans and advances to customers ▸ Banks and customer deposits, including non maturing deposits ▸ HTC or HTC&S Debt securities ▸ Fixed rate subordinated liabilities	▸ Interest rate swaps ▸ Occasionally BGSs		
Foreign exchange risk	Foreign currency denominated: ▸ Subordinated liabilities ▸ HTC or HTC&S Debt securities ▸ Foreign currency expenses	▸ Cross-currency swaps ▸ FX Forwards	FX Hedges can either be CF or FV hedges, but typically CF hedging is applied to avoid ineffectiveness from under hedging		▸ Net investments	▸ Foreign currency debt, typically subordinated debt securities ▸ Cross-currency swaps ▸ FX Forwards

Hedge effectiveness assessment approaches

- Under IAS 39, an entity shall assess at the inception of the hedging relationship, and on an ongoing basis, whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity shall perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first.
- The standard does not specify a particular assessment method and the method chosen by each entity will be dependent on its risk management strategy.
- The method applied for assessing hedge effectiveness may change in response to changes in circumstances. This requires hedging documentation to be updated.
- The most common methods used are as follows

	Description
Critical Terms Match	▸ This method consists of comparing the critical terms of the hedging instrument with those of the hedged item. ▸ The hedge relationship is expected to be highly effective where all the principal terms of the hedging instrument and the hedged item match exactly – for example, notional, credit risk, term, re-pricing dates, timing, and currency/interest rate of cash flows. ▸ This method does not require any calculations
Dollar Offset	▸ This is a quantitative method that consists of comparing the change in fair value or cash flows of the hedging instrument with the change in fair value or cash flows of the hedged item attributable to the hedged risk. ▸ This test can be performed either (1) on a cumulative basis (i.e., with the comparison performed from the inception of the hedge), or (2) on a period-by-period basis (i.e., with the comparison performed from the last testing date). ▸ A hedge is highly effective if the results are within the range of 80%-125%.
Linear Regression	▸ This is a statistical method that involves determining R2 and slope that helps to understand whether changes in the hedged item and hedging derivative are highly correlated

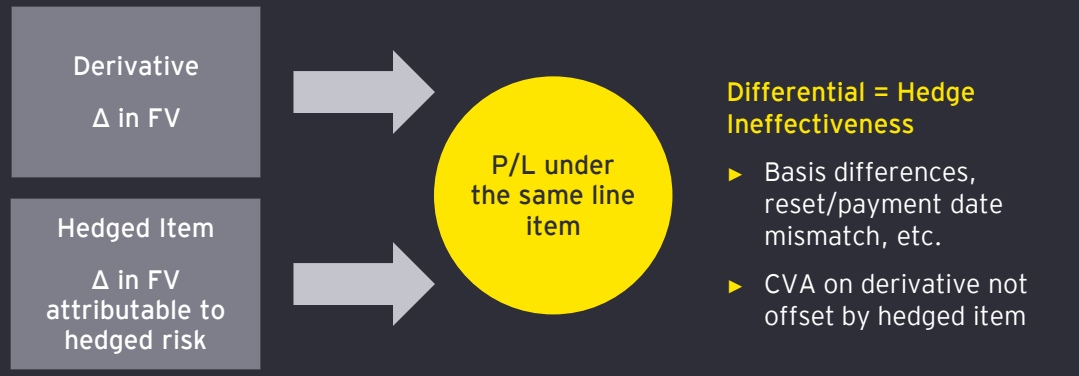
Hedge Accounting Process Flow



03 Accounting Models

Fair Value Hedge Accounting

Accounting for fair value hedges



Differential = Hedge Ineffectiveness

- Basis differences, reset/payment date mismatch, etc.
- CVA on derivative not offset by hedged item

Fact pattern – fixed rate bond issuance

- Bank A issued fixed rate bond in its functional currency (GBP)
- Bank A executed interest rate swaps on 1 December 2023 to hedge the fair value movement on account of interest rate risk
- The following is the impact on the income statement pre and post application of hedge accounting in the period to 31 December 2023

Reporting date	Change in fair value of hedged item*	Change in fair value of derivative
01-Dec-23	0	0
31-Dec-23	(865)	1,000

* attributable to the hedged risk

Accounting for gains/loss

Gain/Loss on	Accounted for in
Hedging instrument	P/L, except the hedging instrument hedges an equity instrument measured at FVOCI.
Hedged item – measured at amortised cost	Profit or loss (P/L)
Hedged item – measured at FVOCI	Profit or loss (P/L)
Hedged item – equity instrument designated at FVOCI	OCI

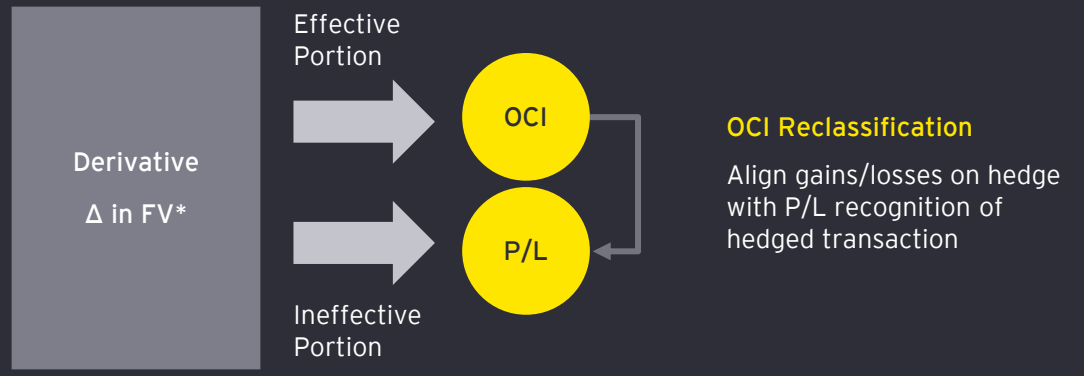
P/L Line Item	Before Hedge Accounting	Hedge Adj	After Hedge Accounting
Interest expense	(100)	(865) + 865	(100)
Gains/(losses) on derivatives	1,000	(865)	135
Net P/L	**900**	(865)	**35**

BS Line Item	Before Hedge Accounting	Hedge Adj	After Hedge Accounting
Debt	(100,000)	(865)	(100,865)
Derivatives	1,000		1,000

Note:
- The highlighted numbers are the net P/L impact pre and post application of hedge accounting

Cash Flow Hedge Accounting

Accounting for cash flow hedges



OCI Reclassification

Align gains/losses on hedge with P/L recognition of hedged transaction

Effective portion

The effective portion of changes in fair value of the hedging instrument is recognised in a separate component of equity 'the cash flow hedging reserve'. The amount recognised in OCI should be the 'lower of':

- The cumulative gain or loss on the hedging instrument from the inception of the hedge, and
- The cumulative change in the fair value (present value) of the expected cash flows on the hedged item from the inception of the hedge

Ineffective portion

If the cumulative change in the hedging instrument exceeds the change in the hedged item (sometimes referred to as an 'over-hedge'), ineffectiveness will be recognised in the P/L. Under-hedging is ignored.

Fact pattern – forecast fixed rate bond issuance

- Bank A has decided to issue a fixed rate bond of CU200 million on 1 Jan 2023 with a 5 year maturity.
- Bank A executes an interest derivative on 1 December 2022 to hedge variability in cash flows due to the changes in the interest rates between 1 December 2022 and 1 Jan 2023, when the fixed rate of the bond is struck (at 3.5%).
- Following is the impact on income statement pre and post application of hedge accounting

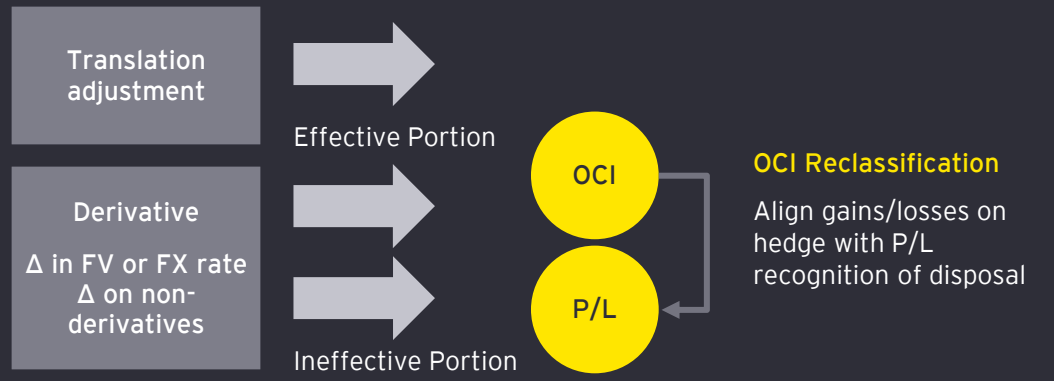
P/L Line Item	Before Hedge Accounting	Hedge Adj	After Hedge Accounting
31-Dec-2022			
Interest expense	-	-	-
Gains/(losses) on derivatives	10,000	(10,000)	-
Net P/L	**10,000**	(10,000)	-
31-Dec-2023			
Interest expense	(7,000)	2,000	(5,000)
Gains/(losses) on derivatives			-
Net P/L	**(7,000)**	**2,000**	**(5,000)**

BS Line Item @ 31-Dec-2022	Before Hedge Accounting	Hedge Adj	After Hedge Accounting
Derivatives	10,000		10,000
Cash flow hedge reserve (gains)/losses – OCI		(10,000)	(10,000)

BS Line Item @ 31-Dec-2023	Before Hedge Accounting	Hedge Adj	After Hedge Accounting
Derivatives	-		-
Cash flow hedge reserve (gains)/ losses – OCI		(10,000) + 2,000	(8,000)

Net Investment Hedge Accounting

Accounting for net investment hedges



- The effective portion of any gains or losses on the hedging instrument is accounted for in equity (currency translation reserve) similar to a cash flow hedge.
- Ineffective gain or loss will be recognised in P/L (based on the 'lower of' test).

Fact pattern

- Bank B, whose functional currency is the EURO, has a net investment in a foreign subsidiary of GBP 60 million. On 1 Jan 2023, Bank B enters into a foreign exchange forward contract to sell GBP 60 million and receive euro on 30 June 2023.
- Bank B will review the net investment balance on a quarterly basis and adjust the hedge to the value of the net investment. The forward element of the forward contract is excluded from the designated hedging instrument. Bank B does not account for the forward element as costs of hedging.

Reporting date	Fair value of forward
01-Jan-23	0
31-Mar-23	850

P/L Line Item 31-Mar-23	Before Hedge Accounting	Hedge Adj	After Hedge Accounting
Gains/(losses) on derivatives	850	(900)	(50)
Net P/L	850	(900)	(50)

BS Line Item @ 31-Mar-2023	Before Hedge Accounting	Hedge Adj	After Hedge Accounting
Derivatives	850		850
Net investment in subsidiary	(900)		(900)
Foreign currency translation reserve (OCI)	900	(900)	-

04 Hedging Strategies in a volatile interest rate environment

Impact of rising interest rates

P/L and OCI volatility arising from positions not included in hedge accounting programs

- Pipeline hedges
- Structural hedges of on demand deposits and/or equity
- Inflation linked FVOCI assets

Increased hedge ineffectiveness

- Sources of ineffectiveness due to mismatches between hedged items and hedging instruments in macro and proxy hedge accounting solutions can have greater impact during periods of large rates movements
- Can cause hedges to fail effectiveness tests

Reduction in hedge accounting capacity

- Greater demand for economic hedging may reduce macro cash flow hedge accounting capacity
- Rising interest rates may change customer behaviour

Greater management focus on hedge accounting

- Identification and mitigation of risks may lead to demand for new hedge accounting strategies
- Better management information to explain impact of hedge accounting on the P/L

How is market responding?

Develop a proxy macro cash flow hedging capability

- Allows users to manage accounting volatility arising from pipeline and structural hedging

Consider using 'carved out' version of IAS 39

- Allows use of modelled on demand deposits as hedged item, supporting management of accounting volatility arising from structural hedging of these products

Review other positions not hedge accounted

- Is there another way of managing the volatility?
- Has the FV option been considered?

Increase capacity of existing proxy macro cash flow hedging capability

- Identify other assets and liabilities on the balance sheet that can contribute to capacity

Ensure customer behaviour is monitored closely and reflected in hedge accounting capacity

- Prepayments on fixed assets
- Withdrawals of on demand deposits

Improve effectiveness and reduce ineffectiveness

- Reduce sources of ineffectiveness, where possible, when matching hedged items with hedging instruments in new hedges
- Consider modifying existing borderline effective hedges
- Introduce regression testing to reduce risk of failure

Invest in systems and tools that can better support your hedge accounting

- Increase hedge accounting strategies available
- Automate processes and controls
- Enhance effectiveness testing and data to explain P/L

Consider outsourcing your hedge accounting

- Reduce investment in systems/tools
- Reduce need for highly sort after internal hedge accounting specialists

Question Time


Thank
you

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