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IASB starts ‘long journey’ to overhaul macro hedging

by Richard Crump 17 Apr 2014

THE WAY banks account for financial risk is to fundamentally change as part on an overhaul to macro hedge accounting proposed by the IASB.

Banks generally manage interest rate risk on a portfolio basis but are required to use a "fearsomely complex" approach to macro hedging under IFRS in which they are required to account for risks on an individual contract basis.

Applying the standards can lead accounting discrepancies and has proved so controversial that the European Union introduced a carve-out in 2005 that allows financial institutions to forego the reporting of such variations.

The changes, proposed by the IASB in a consultation paper, aim to simplify hedge accounting by adopting a portfolio-based approach instead of the line-by-line method currently used.

"The discussion paper purposely asks more questions than the IASB has answers for. It is the start of what will be a long journey to solve the ongoing debate as to how to best account for banks' macro hedging of interest rates," said Andrew Spooner, financial instruments lead partner at Deloitte.

Under the portfolio revaluation approach, exposures that are risk-managed using macro hedging would be revalued for changes in the managed risk through profit and loss. Additionally, fair value changes arising from risk management instruments, such as derivatives, that are used to manage risk would be recognised in profit and loss.

"Current requirements make it difficult to faithfully represent dynamic risk management in entities' financial statements and can increase operational complexity," said Hans Hoogervorst [pictured], chairman of the IASB.

The IASB is currently replacing IAS 39, the accounting standard for financial instruments heavily criticised in the wake of the financial crisis. That project is in the final stages of completion. However, macro hedging component is being treated as a separate package of these reforms.

"When IFRS 9 was developed, the IASB took strides to make the accounting better reflect risk management activity. This discussion paper goes further and asks how this can be done for more complex and dynamic hedging strategies used by banks, where the volume of hedging transactions and exposures is far greater and the hedging is done at a far more aggregate level," said Spooner.

"If some of the ideas discussed in the paper were finalised it would fundamentally change banks' accounting for lending and deposits."

The discussion paper: *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* is available for comment until 17 October 2014.