Introduction

**Purpose of this paper**

1. This paper considers only portfolio fair value hedges of interest rate risk. Portfolio cash flow hedges of interest rate risk will be discussed in a separate staff paper.

2. The purpose of this paper is to:

   (a) briefly discuss the challenges with hedge accounting for open portfolios of existing hedged items (see paragraphs 4 to 7); and

   (b) set out high-level issues related to portfolio fair value hedge accounting of interest rate risk, including issues that will be addressed as part of the general hedge accounting model (see paragraphs 8 to 10 and Appendix A).

3. This paper does not ask for any Board decisions. Its purpose is to provide an initial outline of the issues and an opportunity for the Board to comment on them.
Challenges with fair value hedge accounting for open portfolios of existing items

4. Hedging open portfolios of existing items introduces hedge accounting challenges because of the basic mechanics of fair value hedge accounting. These mechanics ultimately aim to:
   (a) achieve matching in profit or loss of hedging instrument gains/losses with hedged item losses/gains; and
   (b) ensure hedge ineffectiveness is recognised immediately in profit or loss.

5. Fair value hedge accounting requires re-measurement of the existing hedged item for changes in the hedged risk. Therefore it is necessary to know when a hedged item is derecognised. As a result it is necessary to distinguish between the original hedged item that was designated in the hedging relationship and items that subsequently come into existence or were previously not designated as hedged items.

6. The effect of this is that a portfolio that may be hedged as an open group for economic purposes is in effect forced into a closed group scenario for hedge accounting purposes. The exception is that such a closed group does not remain the same for the full term of the hedge. Instead, periodically the closed group will be de-designated and a revised closed group including additional new hedged items or hedging instruments would be re-designated in its place. This introduces complexity.

7. Further complications arise from the fact that the hedged items in a portfolio fair value hedge of interest rate risk often include prepayment options whose fair value change as interest rates change. The fair value changes must be captured for assessment of hedge effectiveness (for qualification purposes) and measurement of hedge ineffectiveness (that is recognised in profit or loss).

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1 In accordance with the Board’s tentative decision on presentation of fair value hedges the adjustments of the hedged item would be presented as separate line items.
Issues related to portfolio fair value hedges of interest rate risk

8. The issues to be discussed by the Board in due course are listed in Appendix A. They are in no particular order of priority or importance and are separated into categories covering different aspects of hedge accounting.

9. It should be noted that some of these issues are not (only) relevant to portfolio hedging but are issues that are best addressed as part of the general hedge accounting model (eg hedged item eligibility issues noted in paragraphs A4 and A5).

10. Also, some of the issues will not be discussed in a portfolio hedging context until they have first been fully discussed as part of the general hedge accounting model (eg assessment of hedge effectiveness issues noted in paragraphs A6 and A7).

Appendix A – outline of hedge accounting issues related to portfolio fair value hedging of interest rate risk

Eligibility of hedged items

A1. Should on-demand and short-term deposits qualify for fair value hedge accounting based on their expected withdrawal behaviour when this is later than contractual maturity? Furthermore, can future replacements of current deposit balances be included as the hedged item in a fair value hedge (ie can the 'core' deposit balance, which does not distinguish between current and future deposits qualify as the hedged item in a portfolio fair value hedge?)

A2. Should interest bearing assets and liabilities be permitted to be hedged together as one group that is a net position?

A3. Should a hedged portfolio of prepayable fixed rate assets (liabilities) be eligible to be hedged for both foreign exchange risk and interest rate risk together (eg using cross currency interest rate swaps)?
A4. Should fixed rate deposits issued at sub-LIBOR swap rates qualify for fair value hedge accounting for changes in LIBOR (up to contractual maturity)?

A5. Should non-contractually binding but public offers of mortgages at stated fixed rates (often referred to as pipeline mortgages) be eligible for fair value hedge accounting in the hedged portfolio?

Assessment of effectiveness (for qualification)

A6. Should management’s assessment of effectiveness for risk management purposes be considered when deciding what might qualify for hedge accounting (eg time bucket apportionment and demonstration of sufficient headroom)?

A7. For portfolio hedges should there be practical expedients to reduce the burden of performing a prospective effectiveness assessments every time the hedge relationship changes (ie when hedged items or hedging instruments are added to, or removed from, the hedge relationship).

A8. Measurement of ineffectiveness (ie calculating the fair value hedge adjustment)

A9. Should a bottom layer approach be permitted to define the hedged item in a portfolio fair value hedge of interest rate risk (such that earlier or later than expected prepayment does not necessarily give rise to hedge ineffectiveness)?

A10. Should all changes in expectation of prepayment (both earlier and later) be excluded from measuring ineffectiveness?

A11. Should changes in fair value of the hedged item be determined with reference to the fixed leg of the interest rate swap used to hedge it?

Amortisation of hedge adjustment

A12. Should a bottom layer approach be used to define the hedged item for hedge adjustment amortisation purposes (ie potentially reducing the burden of amortisation of hedge adjustment in cases where prepayment expectations change or when part of a previously hedged bucket is derecognised due to prepayment, sale or impairment)?
A13. Should an amortisation basis other than straight line or adjusting the effective interest rate method of individual items be permitted for fair value hedge adjustments when hedge accounting ceases?

A14. If portfolio hedge accounting of a net position of fixed rate assets and fixed rate liabilities is permitted must the hedge adjustment be posted to two separate lines depending on whether the hedge adjustment relates to hedged assets or hedged liabilities or can it be presented in one line?