



Hedge accounting Summary of tentative decisions as of 29 October 2010

This document summarises the main tentative decisions made to date on the hedge accounting phase of the project to replace IAS 39.

For those wanting extra information, reference is made to the Board meetings and agenda papers that provide extra information on the decisions summarised. If you refer to the Meetings information on our website www.ifrs.org you will find links to the agenda papers.

This paper is designed to provide high level information - it does not summarise all decisions, nor does it refer to all meetings where hedge accounting has been discussed or all agenda papers.

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation

Timelines

	2010		2011		
	Q3	Q4	Q1	Q2	H2
Hedge accounting		ED*		IFRS	

*This ED will cover the general accounting model. Additionally, the IASB is continuing work on portfolio hedge accounting.

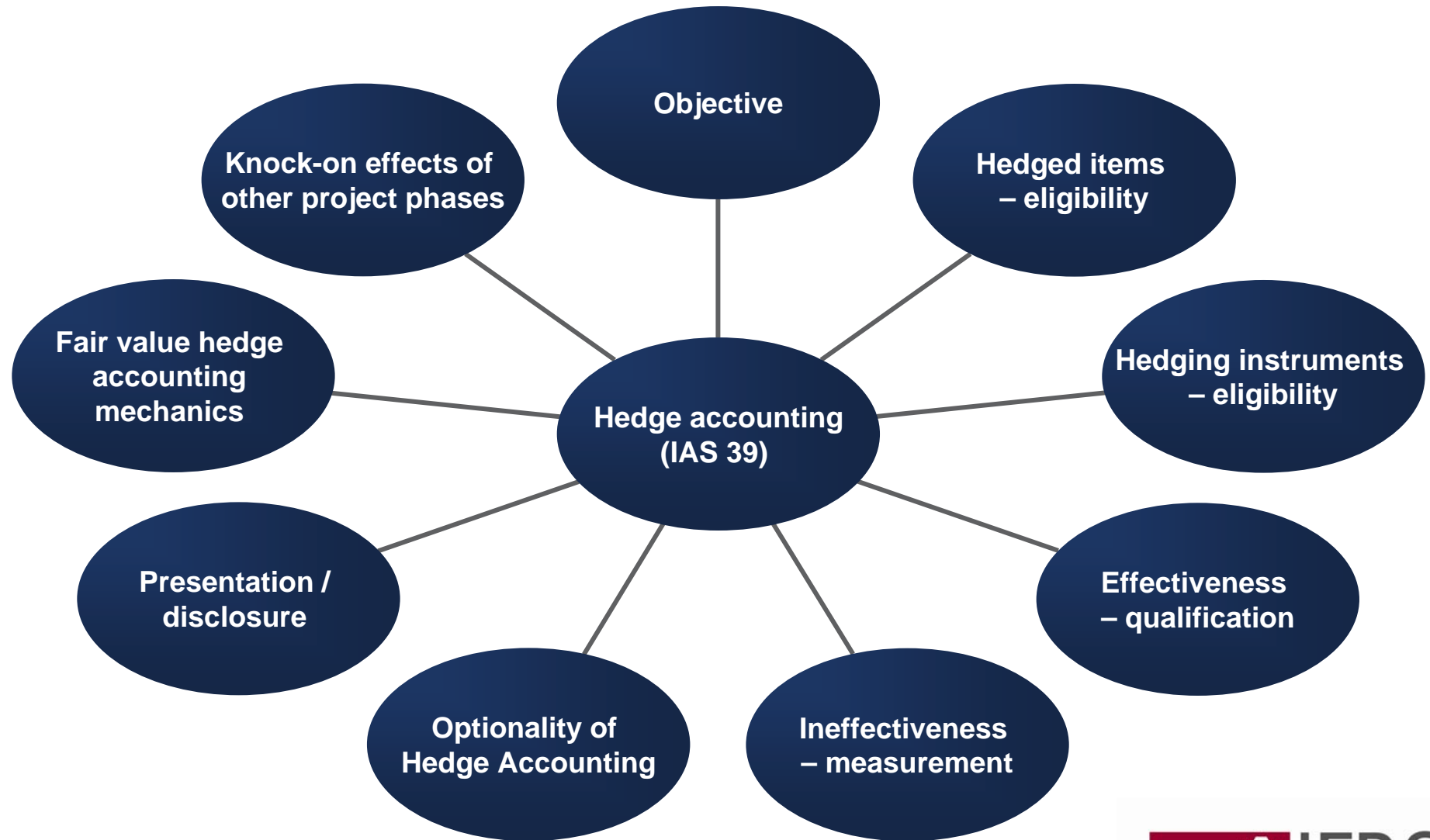
- The Board is considering hedge accounting **comprehensively**
- **Overall approach:**
 - Use existing architecture
 - Address specific problem areas
 - Use clear and explicit principles
 - Identify any exceptions clearly

Hedge Accounting – broad direction

- Simplify hedge accounting
- Consider application to portfolios

This project will not look at hedge accounting for hedges of net investments in foreign operations

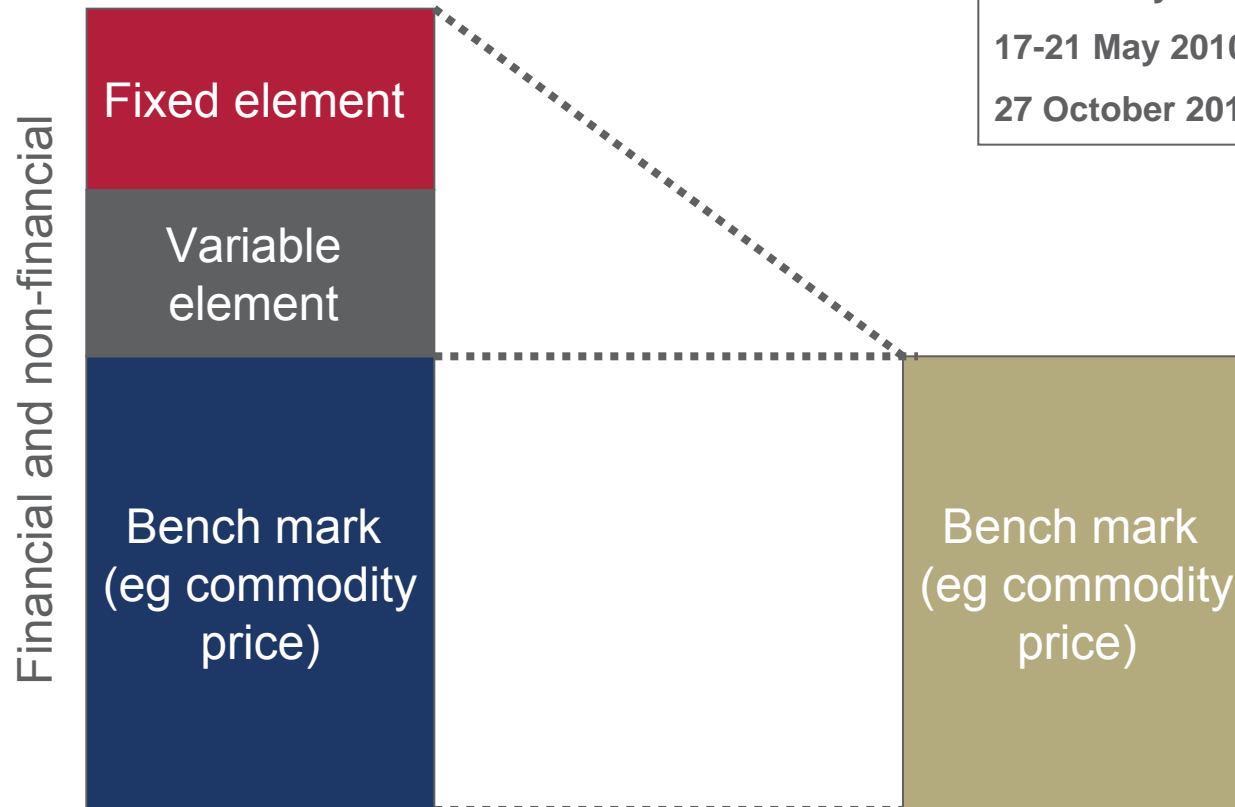
Components of the hedge accounting model



Risk management objective:
Seeks to link risk management and financial reporting (top down)

Accounting objective:
Seeks to manage timing of recognition of gains or losses (bottom up)

Hedged items – risk components



Discussed at following Board meetings:

18-21 January 2010 (8B, 8C)

2 February 2010 (4C)

17-21 May 2010 (9D)

27 October 2010 (3)

- **Tentative decisions:**
 - Align financial and non-financial hedged items
 - Criteria-based approach to identifying risk components
 - Criteria are those for financial hedged items today (ie separately identifiable and reliably measurable) but apply also to non-financial hedged items
 - An entity needs to evaluate the facts and circumstances with regard to the *particular market structure* to which the risk relates and in which the hedging activity takes place

Hedged items – risk components continued

- **Tentative decisions:**

- LIBOR components in sub-LIBOR interest bearing financial instruments

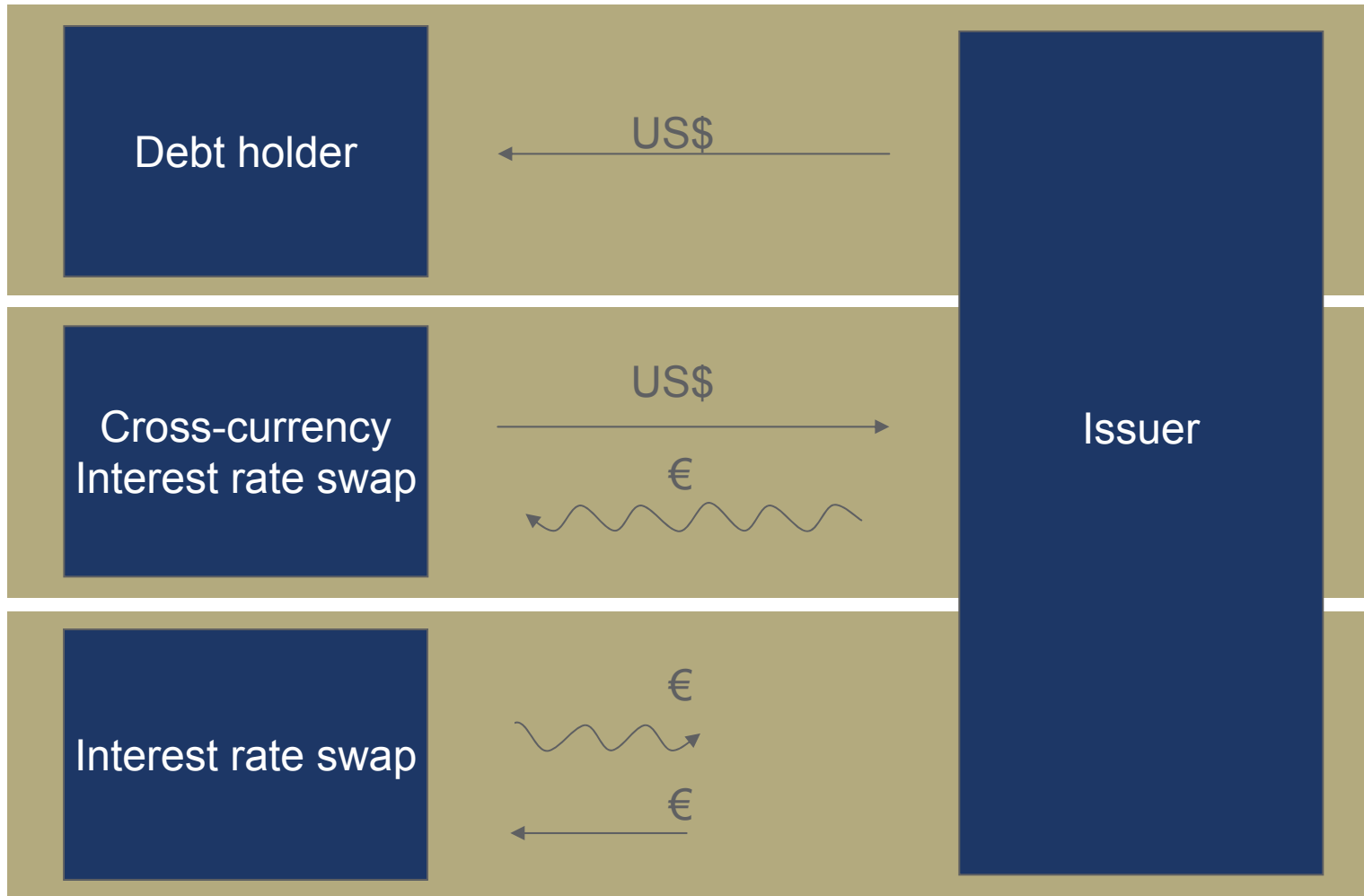
- Designated risk component should *not* exceed the total cash flows of the hedged item

- But: can still designate all the cash flows of the the hedged item (for LIBOR risk!)

⇒ Retain the restriction in IAS 39

See Board meeting:
18-22 October 2010
(16)

Hedged items – derivative as hedged item



Tentative decision:
derivatives can be designated as hedged items in several situations including when hedged exposure is a combination of a derivative and a non-derivative

See Board meeting:
3 March 2010 (1A)

- **Issues:**

- Alignment of hedge accounting with common risk management practice
- Identification and tracking of hedged items in a group hedge
- Net positions – allocation of hedge gains/losses:
 - profit or loss geography (single line vs grossing up of derivative gains or losses)
 - groups that include income/expense items and assets/liabilities

- **Tentative decisions:**
 - Change in fair value of individual hedged items need not be proportional to that of the group
 - Permit layer approach (eg bottom layer) to identifying hedged items from a group (in some circumstances)

See following Board meetings:
17-21 May 2010 (9A)
24 August 2010 (5)

- **Tentative decisions:**

- Net positions as eligible hedged items:

- Conditions:

- Consistent with risk management

- Items identified on a gross basis

- ✓ Fair value hedges

- ✓ Cash flow hedges:

- If offsetting cash flows affect profit or loss in the same period

- Separate line item presentation of hedging instrument gains or losses for net position hedges (in some circumstances)

See Board meeting:

**17-21 May 2010
(9A, 9B, 9C)**

**19-23 July 2010
(6A, 6B, 6C)**

**14-16 September
2010 (14A)**

**18-22 October
2010 (19A, 19B,
19C)**

Hedging instruments – eligibility

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- Tentative decisions:

See Board meeting:
27 October 2010 (4A, 4B)

- Purchased options

- time value of an option—treatment reflects view as purchased protection (‘insurance’) and depends on the type of hedged item:
 - transaction related: eg forecast purchase of a commodity
 - time period related: eg hedging existing inventory
- transaction related: defer cumulative change of option’s time value in OCI (recycled similar to cash flow hedges)
- time period related: amortise option’s time value over the life of the option

Hedging instruments – eligibility continued

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- **Tentative decisions:**

See Board meeting:
27 October 2010 (1, 3)

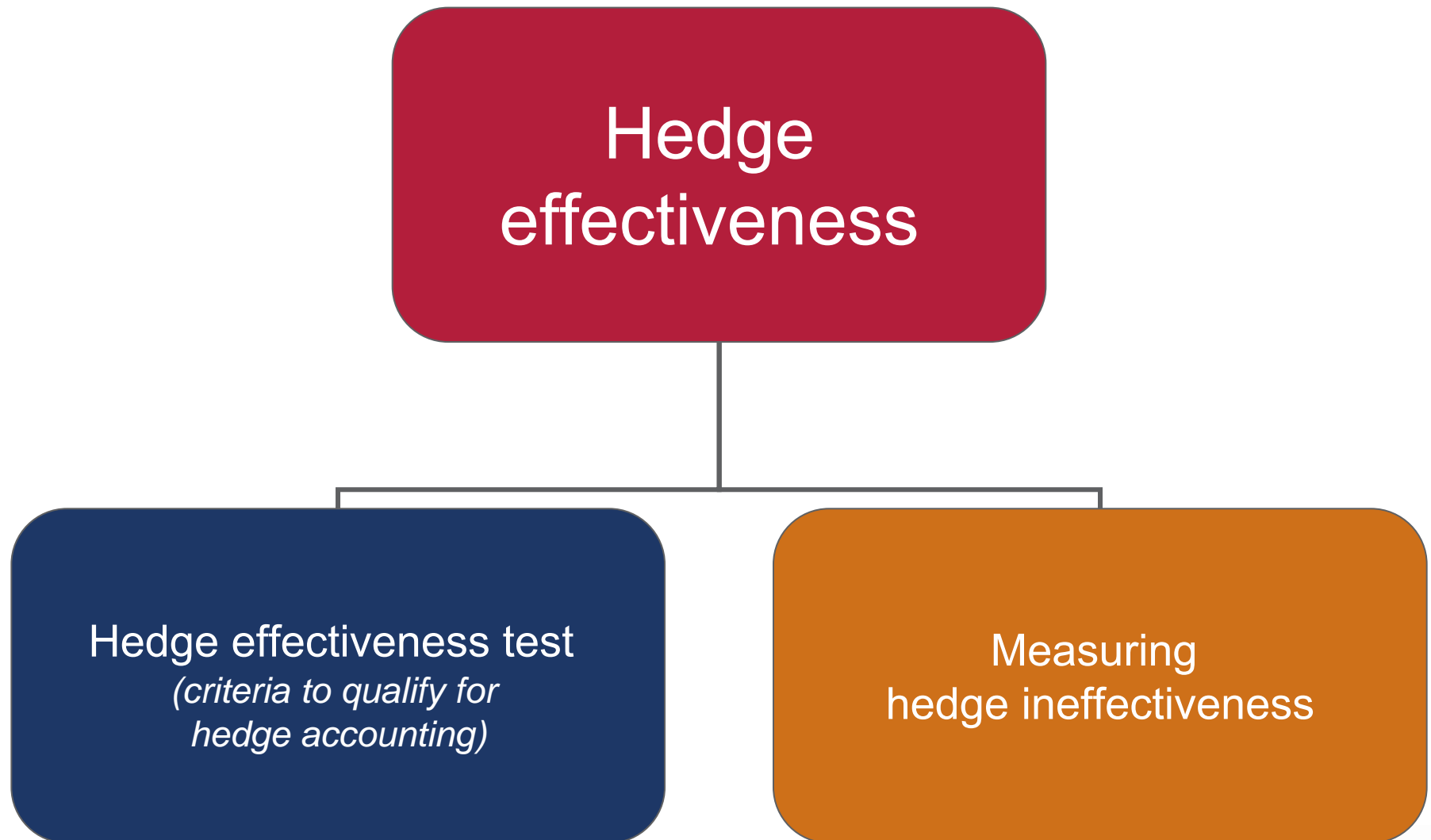
- **Cash instruments:** the designation of non-derivative assets and liabilities is allowed for
 - a hedge of foreign currency risk (ie the FX risk component)
 - for financial instruments at fair value through profit or loss (in their entirety)
- **Risk components:** retain separation of forward points and the time value of options

New accounting (see previous slide!)

Hedge effectiveness (qualification)

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- **Issues:**
 - Requirements to perform quantitative tests are onerous
 - Arbitrary bright lines of 80-125%
 - Failing effectiveness test has severe consequences
 - Insufficient guidance how to quantify effectiveness



Test hedge effectiveness (qualification)

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- **Objective**

- Hedging relationship should produce an unbiased result and minimise *expected* hedge ineffectiveness
- To achieve this:
 - Risk management determines the ‘optimal’ hedge ratio
 - ie no expectation that changes in the value of the hedging instrument will *systematically* exceed or be less than changes in the value of the hedged item
 - Demonstrate offset in hedge relationship is *not* accidental

- **Tentative decisions:**

- No bright-line (ie no 80% to 125% range)
- The characteristics of the hedging relationship and the potential sources of ineffectiveness determine:
 - whether a qualitative or quantitative assessment is appropriate
 - what method of assessment is appropriate
- The assessment is forward looking and performed at inception and on an ongoing basis
- Rebalancing of the hedge ratio and a change of the assessment method can become necessary

See Board meetings:
3 August 2010 (2A)
24 August 2010 (4A)

Recognise hedge ineffectiveness

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- **Tentative decisions:**

- *All* hedge ineffectiveness must be recognised
 - Includes effect of **credit risk**
 - Includes **time value of money** (→ difference in timing of cash flows)
- Measurement on a ‘dollar offset’ basis
- ‘Hypothetical derivative’ ...
 - Not a separate method
 - One possible way to determine the change in value of hedged item

See Board meeting:
14-16 September
2010 (19A, 19B)

- **Tentative decisions:**

See Board meeting:
18-22 October 2010
(17A)

- **Mandatory discontinuation**

- When hedging relationship ceases to meet the qualifying criteria

- **Discontinuation and restart**

- Change in the risk management objective

'Rebalancing'

- **Adjusting a continuing hedging relationship**

- Risk management objective remains the same but fail (or about to fail) other qualifying criteria

- **Dedesignation prohibited**

- When all the qualifying criteria are still met

- **Update documentation**

- **Tentative decisions:**

- **Rebalancing**

- Occurs when:

- Some of the variables affecting the hedging relationship changes beyond the expected level or sources of ineffectiveness

- Is a continuation of an existing hedge in specific circumstances

- Depends upon whether the risk management objective still applies

**See Board meeting:
18-22 October 2010
(17B)**

Rebalancing and discontinuation

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- Tentative decisions:

- Partial discontinuation or restart

- Changes to hedge ratio to reflect new circumstances
- Fail to predict volume of highly probable forecast transactions accurately (provided rare history of downward adjustments)

See Board meeting:
18-22 October 2010
(17C)

- **Issues:**
 - Different mechanics used for fair value and cash flow hedges increase complexity
 - Adjusting hedged item results in a measurement that is neither cost nor fair value
 - Cash Flow hedge accounting mechanics create OCI volatility
 - Presentation of hedging gains or losses

Tentative approach to hedge accounting

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Ways to
account
today

Cash flow hedge accounting

- Unchanged

See initial Board discussion:
14-18 September 2009 (15)

See amendment to initial decision:
19-23 July 2010 (8A, 8C)

Tentative decision to retain lower of test:
6 October 2009 (11)

Tentative changes to the way
we account for hedges today...

Fair value hedge accounting

- Cumulative gain or loss on the hedged item attributable to the hedged risk as a separate line item in the balance sheet
- Hedged item's carrying amount not changed
- The fair value changes for hedging instruments and hedged items are taken to other comprehensive income and any ineffectiveness is transferred immediately to profit or loss

- 'Basis adjustments'
 - Mandatory
 - No distortion of OCI when hedged item is adjusted
- Hedges of FX risk of firm commitments
 - Hedge-by-hedge choice (FVH or CFH) retained

See Board meeting:
14-16 September 2010
(16A, 16B, 16C, 16D)

Interaction with the 'own use' scope exception

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- **Issue:**
 - Managing dynamic net positions
 - Derivatives, executory contracts and physical long positions
 - Hedge accounting not an efficient solution
- **Tentative decision:**
 - Derivative accounting would apply to 'own use' executory contracts if that is in accordance with the entity's fair value-based risk management strategy

See Board meeting:
18-22 October 2010
(18A,18B)

See Board meeting:
18-22 October 2010
(21A, 21B)

- **Issue:**
 - Difficult to isolate and directly measure the credit risk component for hedge accounting purposes
 - Fair value option too restrictive and not available for most loan commitments
- **Tentative decision:**
 - Not to allow elective fair value accounting for part of the nominal amount due to complexity

- **Embedded derivatives**
 - separated embedded derivative features that are available for designation as hedging instruments under IAS 39 disappear under IFRS 9 (for asset host contracts)
- **Impairment**
 - the proposed use of expected loss without an incurred loss threshold raises questions about requirements that hedged cash flows must be *highly probable* of occurring

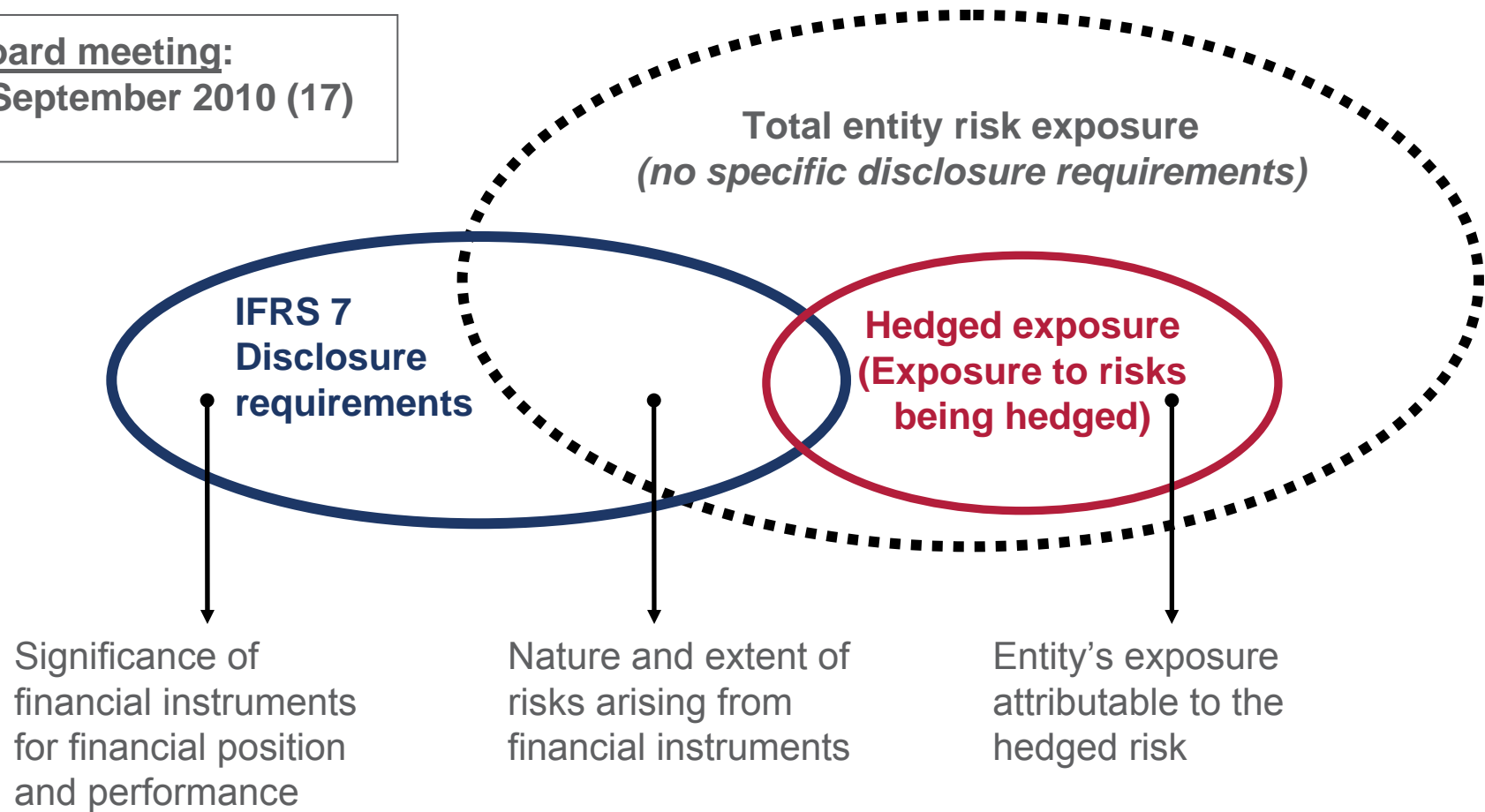
- Equity investments for which the OCI presentation alternative is elected
 - Tentative decision:
 - Prohibit the application of hedge accounting for instruments designated at fair value through OCI

See Board meeting:
24 August 2010 (2)

Disclosures – scope

Proposed scope for hedge accounting disclosures

See Board meeting:
14-16 September 2010 (17)



- Presentation
 - Level of granularity
 - Balance sheet
 - OCI (recycling)

**See Board meeting:
18-22 October 2010 (20A,
20B, 20C, 20D, 20E)**

Tentative decisions:

- Risk management strategy
 - Risks hedged (notional amounts and fair value movements)
 - Instruments used (fair value movements and effectiveness)
 - Hedging relationships
- Forecasting cash flows
 - Period of hedging
 - Rates and cash flows locked in

Transition and effective date

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See Board meeting:
27 October 2010 (2)

- Transition requirements
 - Prospective application of new hedge accounting model to *all* hedging relationships
 - Hedging relationships that qualified under IAS 39 and qualify under the new model will be treated as *continuing* hedging relationships
 - No restatement of comparatives
- Effective date
 - annual periods beginning on or after 1 January 2013 with earlier application permitted

IFRS project vs FASB exposure draft

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IFRS hedge accounting project (comprehensive review)

- Objective
- Hedged items eligibility
- Hedging instrument eligibility
- Effectiveness
- Measurement of ineffectiveness
- Hedge accounting as a choice
- Presentation and disclosure
- Fair value hedge accounting mechanics
- Knock-on effects of other projects

FASB exposure draft (limited changes)

- Eases qualitative testing for hedge effectiveness
- Eliminates 'lower of' test by recognising all ineffectiveness in net income
- Bifurcation by risk (benchmark interest rate risk, foreign currency and credit risk) allowed only for financial items
- Only reassess if circumstances suggest a change
- Prohibits an entity from *electing* to dedesignate

Next steps...

- Deliberations on hedge accounting model have been completed
 - Board has asked staff to begin drafting
 - Deliberations on portfolio hedge accounting to continue
- Exposure draft expected in Q4 2010
- Continued outreach
- IFRS in Q2 of 2011

Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.

