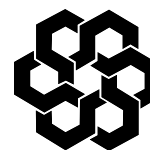

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**13 December 2006, London**
Project:	**Hedge accounting - Other portions**
Subject:	**IAS 39 *Financial Instruments: Recognition and Measurement* - Identification of 'other portions' of an exposure eligible for hedge accounting (Agenda Paper 11)**

INTRODUCTION

1. At its July 2006 meeting, the IFRIC asked the staff to approach the Board for guidance on how to address the issue of what can be designated as a hedged portion under IAS 39.

2. At its October 2006 meeting, the Board acknowledged that additional guidance is required in this area. The Board directed the staff to develop a proposal regarding the form and content of any additional guidance.

SCOPE OF THIS PAPER

3. This paper only focuses on situations in which a financial instrument, or some part of a financial instrument, is designated as a hedged item.

4. This paper does NOT address whether a financial instrument in its entirety can be designated as a hedged item for hedge accounting. IAS 39 clearly allows a financial instrument in its entirety to be designated as a hedged item.

5. IAS 39 does allow an entity to hedge all of the cash flows of an entire financial instrument for one or more specific risks[1]. However, IAS 39 does not specify what risks are eligible for hedge accounting. IAS 39 only states that the risks being hedged must be identifiable and separately measurable (see IAS 39.81 and AG 98 of IAS 39).

6. This paper addresses two issues. The first is whether IAS 39 should specify the risks that are eligible for designation.

7. The second issue addressed by this paper relates to situations in which a portion of a financial instrument is designated as a hedged item.

8. In this paper, the staff use the word 'portion' in situations other than when:

   - all of the cash flows of the entire financial instrument are hedged for all risks; and
   - all of the cash flows of the entire financial instrument are hedged for changes attributable to one or more specific risks.

9. Different types of portions of a financial instrument that qualify for hedge accounting in IAS 39 include:

   (a) the future cash flows of the financial instrument for part of its time period to maturity (a 'partial term' hedge);

   (b) a percentage of the future cash flows of the financial instrument for its whole life or part of its time period to maturity (a 'proportion');

   (c) the future cash flows of the financial instrument associated with a one-sided risk of the financial instrument; and

   (d) '**other portions**' of the future cash flows of the financial instrument for its whole life or part of its time period to maturity.

---

[1] AG 99C of IAS 39 states: 'the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for one particular risk (eg only for changes that are attributable to changes in LIBOR).'

10. Since the portions explained in bullet points (a) and (b) above are self-explanatory, this paper does NOT discuss them further.

11. Regarding bullet point (c) above, IAS 39 specifically permits an entity to hedge a one-side risk of a financial instrument (e.g. the downside price risk of an equity instrument - see F.1.10 of the Guidance on Implementing IAS 39). The staff will discuss this type of portion later in this paper.

12. The lack of guidance on what **'other portions'** of a financial instrument can be designated as hedged items (see item (d) above) has led some to conclude that **'other portions'** of a financial instrument could be anything, subject only to the restriction imposed by paragraph 99C of IAS 39 (that the designated portion must be less than the total cash flows of the hedged item).

13. Therefore, the second issue addressed in this paper is whether to clarify what (and if so, how) '**other portions**' of a financial instrument are eligible for designation.[2]

14. [Paragraph omitted from observer note].

15. [Paragraph omitted from observer note].

16. It is important to note that the staff recommendations in this paper do not seek to prohibit any exposures that are currently eligible to be hedged under IAS 39.

17. Instead, this paper aims to clarify:

    - what risks can be designated when all of the cash flows of the entire financial instrument are hedged; and
    - what '**other portions**' of a financial instrument can be designated as hedged items.

SUMMARY OF THE APPROACHES TO THE ISSUES

Issue 1: When all of the cash flows of the entire financial instrument are hedged for one or more specific risks, should IAS 39 specify the risks that are eligible for hedge accounting?

---

[2] And, to be clear with regard to the type of portion we are discussing, we will label this type of portion as an **'other portion'** throughout this paper.

18. This paper discusses the following two views:

- View 1 – To amend IAS 39 to specify the eligible risks. For example, under US GAAP the eligible risks are foreign currency, benchmark interest rate and credit risk (or a combination of two or more of those risks); or
- View 2 – No specification of the eligible risks in IAS 39 (that is, no change to IAS 39 in this area). As mentioned above, IAS 39 requires that the risks being hedged must be risks that can be identified and separately measured.

Issue 2: What 'other portions' of a financial instrument are eligible to be designated as hedged items?

19. This paper analyses four possible approaches to restricting the number of eligible portions:

- Approach 1 – Remove the ability to hedge a portion of a financial instrument ("Abolish **other portions**");
- Approach 2 - Develop a principle which could be used to determine what **'other portions'** can be designated as hedged items ("Develop a principle for **other portions**");
- Approach 3 - Converge with US GAAP in this area ("Converge with US GAAP"); or
- Approach 4 – Specify '**other portions**' of a financial instrument that are commonly understood by the Board to qualify as hedged items ("Specify **other portions**").

Linkage between Issues 1 and 2

20. There is linkage between Issues 1 and 2. For example, if the Board decide to specify the eligible risks (View 1) with regard to Issue 1, then the Board need to consider what portions of the financial instrument associated with those risks can be designated as hedged items under Issue 2.

21. Alternatively, if the Board decide not to specify the eligible risks (View 2) in Issue 1, the Board will need to specify the risks in Issue 2 when the Board identifies what **'other portions'** of a financial instrument are eligible for designation.

STAFF ANALYSIS

Hedging all of the cash flows of the entire financial instrument for one or more specific risks vs. hedging 'other portions' of a financial instrument

22. Before continuing, it is important to understand the difference between (i) hedging all of the cash flows of the entire financial instrument for one or more specific risks, and (ii) hedging 'other portions' of a financial instrument. The following example is used to demonstrate the difference.

    - An entity has a CU 1,000 fixed rate asset paying interest at 10% (assume that this asset is not accounted for as a financial asset at fair value through profit and loss).
    - The entity enters into an interest rate swap at market rates under which the entity pays 7% fixed/receives LIBOR.

Hedging all of the cash flows of the entire financial instrument for one or more specific risks

23. Using the above example, the entity designates all of the cash flows of the entire fixed rate asset (i.e. CU 1,000 + 10% interest) as a hedged item for a risk attributable to changes in LIBOR.

24. In assessing hedge effectiveness, the entity would compare changes in the fair value of the whole asset attributable to changes in LIBOR with changes in the fair value of the swap. (This is the approach generally required by US GAAP).

25. However, a relationship designated in this way will give rise to ineffectiveness.

Hedging 'other portions' of a financial instrument

26. An entity designates a LIBOR portion of the fixed rate asset as a hedged item, and hedges that portion for a risk attributable to changes in LIBOR.

27. To maximise hedge effectiveness, the entity designates as a hedged item a portion of the cash flows of the fixed rate asset, which is equal to cash flows of a 7% CU 1,000 fixed rate asset.

28. In assessing hedge effectiveness, changes in the fair value of the hedged portion (i.e. CU 1,000 plus 7% interest) attributable to changes in LIBOR are compared with changes in the fair value of the swap.

29. If the principal terms of the swap and the asset match, no ineffectiveness would arise.

30. The ability to hedge such a portion of a financial instrument means that a reporting entity can designate a hedged item in such a way that, in many cases, no ineffectiveness will arise.

*Why is it necessary to restrict the designation of '**other portions**' of a financial instrument as hedged items to certain situations?*

31. One of the key hedge accounting requirements in IAS 39 is that actual hedge ineffectiveness should be recorded in the profit or loss. If the view that **'other portions'** of a financial instrument can be anything is accepted, the requirement to record hedge ineffectiveness in the profit or loss becomes meaningless. To maximise hedge effectiveness, the hedged portion will always be designated in such a way that it mirrors the hedging instrument.

32. Consequently, in addressing issue 2, this paper examines possible approaches to restricting the number of eligible portions to those that were originally envisaged by the Board.

Issue 1: When all of the cash flows of the entire financial instrument are hedged for one or more specific risks, should IAS 39 specify the risks that are eligible for hedge accounting?

33. The following section discusses two views regarding whether IAS 39 should specify the risks that are eligible for hedge accounting, when all of the cash flows of the entire financial instrument are hedged for one or more specific risks.

View 1 – Specify eligible risks

34. No specification of eligible risks in IAS 39 has led some to believe that it was appropriate to designate any risks loosely construed to be a part of a financial instrument as a hedged item. As a result, the following issues arise:

   - some would like to hedge changes in the fair value of a fixed rate debt instrument attributable to changes in inflation rates or changes in a commodity price (such as oil price); and
   - if such risks can be hedged, an additional question arises as to how to calculate changes in the fair value of the financial instrument attributable to such risks? Some suggest that it is feasible to determine changes in the fair value of the instrument attributable to changes in inflation rates. It is not, however, at all clear how to determine changes in the fair value of the instrument attributable to changes in oil prices.

35. If there is no specification of eligible risks, in the staff's view, it is very likely that constituents will submit requests for Interpretations in this area in the future.

<u>Specify risks similar to those eligible under US GAAP</u>

36. View 1 would specify the eligible risks similar to those under US GAAP.

37. US GAAP restricts the risks that can be designated as hedged risks to the overall risk of changes in the cash flows or fair value risk to benchmark interest rate risk, foreign currency risk and credit risk[3] (or a combination of one or more of these risks).

---

[3] 'Credit risk' refers to the risk of changes in the fair value of a financial instrument attributable to changes in the obligor's creditworthiness (see paragraph 21(f) of Statement 133).

Specify prepayment risk as an eligible risk

38. If View 1 is adopted, the staff believe that IAS 39 should also specify prepayment risk as an eligible risk.

39. [Paragraph omitted from observer note].

40. [Paragraph omitted from observer note].

41. [Paragraph omitted from observer note].

42. If View 1 is adopted, the staff also believe that IAS 39 should also allow a risk associated with the cash flows of a financial instrument that are contractually specified, and are independent of other cash flows of the same financial instrument (that is, neither cash flows are dependent upon each other) to be designated as a hedged risk).

43. For example, an entity has a debt instrument that pays a return of inflation rate plus two per cent. Assuming that the entity is not required to separately account for the embedded derivative from the host contract, the entity should be allowed to hedge all of cash flows of the entire debt instrument for changes attributable to changes in the inflation rates.

44. However, if a debt instrument pays a return of a fixed rate which is equal to inflation rate plus the residual, the entity should not be allowed to designate the changes in the inflation rates as a hedged risk because the inflation rate and the residual rate are dependent upon each other.

45. View 1 is rule rather than principle based. However, it would provide clear guidance and remove the possibility of future requests for Interpretations in this area.

View 2 – No specification of eligible risks

46. An alternative is to do nothing with respect to Issue 1. That means, provided that the risks being hedged can be identified and separately measured, they can be designated as hedged risks under IAS 39 (see IAS 39.81 and AG 98 of IAS 39).

Issue 2: What 'other portions' of a financial instrument are eligible to be designated as hedged items?

47. As mentioned earlier, the aim of this paper is NOT to prohibit portions of a financial instrument that are specifically allowed to be designated as hedged items under IAS 39.

48. For example, as previously discussed, F.1.10 of the Guidance on Implementing IAS 39 specifically allows an entity to hedge the downside price risk of an equity instrument with a purchased option. The corresponding hedged portion associated with the downside price risk is the price decline below the exercise price of the option.

49. Therefore, the portions of a financial instrument associated with such a one-sided risk would continue to be permitted to be designated as hedged items under the staff recommendations in this paper.

50. As mentioned previously, one of the purposes of this paper is to clarify the boundaries of what '**other portions**' of a financial instrument can be designated as hedged items. This paper considers four possible approaches to clarifying those boundaries. There may be other possible approaches.

51. Each of the four approaches is analysed below. In assessing the advantages and disadvantages of these approaches, the staff have considered the following factors:

   - Does the approach restrict the number of eligible '**other portions**'?
   - Is the approach consistent with the Board's long term objectives[4] – does the approach simplify or eliminate the need for special hedge accounting requirements?
   - Impact on practice – what effect would the approach have on current practice?

[4] The IASB and FASB have three long-term objectives for simplifying and improving the accounting for financial instruments: 1) To require all financial instruments to be measured at fair value with realised and unrealised gains and losses recognised in the period in which they occur; 2) To simplify or eliminate the need for special hedge accounting requirements; and 3) To develop a new standard for the derecognition of financial instruments.

- Resource issues – would the approach require significant Board, IFRIC or staff resources?
- Convergence – to what extent would the proposed approach lead to convergence with US GAAP[5]?

52. A summary of the advantages and disadvantages of the four approaches is provided in Appendix 1 to this paper.

*Approach 1 - Abolish '**other portions**'*

53. Under this approach, IAS 39 would be amended to remove an entity's ability to designate **'other portions'** of a financial instrument for hedge accounting purposes.
54. This approach would result in a simplification of the hedge accounting requirements in IAS 39.
55. However, if the Board decided to remove the permission to hedge **'other portions'** of a financial instrument from IAS 39, it would result in a large impact on existing practice. As discussed previously in this paper, the ability of a reporting entity to hedge only a portion of a financial instrument means that the hedge relationship is much likely to pass the effectiveness qualification tests and less likely to result in any ineffectiveness being reported. If the concept of '**other portions**' was abolished, many of the current hedging relationships would need to be redesignated with the increased risk that those relationships would fail the effectiveness qualification tests and/or reported ineffectiveness would increase.
56. Consequently, the staff believe that if this approach was adopted, the Board should also consider making other amendments to IAS 39. For example, the Board could consider including the shortcut method[6] in IAS 39 or abolish the effectiveness qualification (80 – 125) test. [Sentence omitted from observer note].

---

[5] The Boards of the IASB and FASB have committed to work towards convergence of the accounting for financial instruments.

[6] Statement 133 allows an entity to assume no ineffectiveness in a hedge of interest rate risk using an interest rate swap as the hedging instrument, provided specified criteria are met (the 'shortcut method'). The shortcut method is not permitted under IAS 39. As explained in paragraph BC135 of IAS 39, one of the main reasons for not permitting the shortcut method in IAS 39 is the ability of an entity to hedge portions of financial assets and liabilities leading, in many cases, to no ineffectiveness being recognised.

57. This approach would, to some extent, represent convergence with US GAAP. Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities* only permits a specific portion of a financial instrument to be designated as a hedged item in restricted situations[7]. However, Approach 1 would not lead to full convergence with US GAAP.

58. Any move to abolish portions would represent a substantial change to IAS 39. This could involve significant Board and staff resources and, possibly, would involve a comprehensive reconsideration of the current hedge accounting requirements which is beyond the current scope of this project.

*Approach 2 - Develop a principle for '**other portions**'*

59. The staff have already made a number of attempts to develop a principle which could be used to determine what '**other portions**' of a financial instrument can be designated as hedged items. For example, the staff have considered developing guidance based upon a principle that changes in the fair value or cash flows of a designated portion of a financial instrument must be correlated to changes in the fair value or cash flows of the financial instrument as a whole.

60. However, all the principle-based approaches that the staff have so far considered are difficult to apply in practice. For example, in the correlation approach mentioned above, what level of correlation between the portion and the overall financial instrument would be required for the portion to qualify for designation as a hedged item? As a result, the staff believe that a principle-based approach to portions is unlikely to simplify the hedge accounting requirement of IAS 39.

61. In addition, the staff believe that developing a principle on this aspect would involve significant Board and staff resources as the staff's experience to date has shown that this is a controversial area.

[7] For example, paragraph 21a (2) of Statement No. 133 permits an entity to designate the following items as hedged items in a fair value hedge: (a) a percentage of the entire asset or liability; (b) one or more selected contractual cash flows; (c) an embedded put or call option; (d) the residual value in a lessor's net investment in a direct financing or sales type lease.

62. It is not possible to determine (at this stage) what effect this approach would have on current practice or whether it would result in effective restrictions on what can be qualified as a portion; this would depend upon the principle developed.

63. This approach to portions would not lead to convergence with US GAAP.

Approach 3 - Converge with US GAAP

64. Under Statement 133, a reporting entity must hedge the entire financial instrument for one or more specific risks – with a number of exceptions[8]. However, US GAAP does include the shortcut method. [Sentence omitted from observer note].

65. The US GAAP approach is therefore very different from IAS 39. Any move to fully converge with US GAAP would represent a significant change which would have a major impact on practice.

66. [Paragraph omitted from observer note].

67. As full convergence with US GAAP would represent a significant change to the hedge accounting requirements of IAS 39, it is likely that this approach would require significant Board and staff resources. In addition, it is unlikely that convergence with US GAAP would result in simplification of the hedge accounting requirements of IAS 39.

68. However, converging with US GAAP in this area could relieve some pressure on the IFRIC and staff that may arise in the future to develop hedge accounting guidance.

Approach 4 – Specify ***'other portions'***

69. Under this approach, the ability to designate **other portions** as hedged items would be restricted to certain specified situations.

70. There are various ways in which '**other portions**' that would qualify as hedged items could be specified.

71. As mentioned earlier, if the Board decide to specify the eligible risks in Issue 1, those eligible risks could form the basis for the identification of any eligible portions for hedge accounting.

---

[8] See previous footnote.

72. Alternatively, if the Board decide not to specify the eligible risks in Issue 1, the portions of a financial instrument could be identified by considering the most common portions in hedge accounting relationships. The Board could restrict the designation of **'other portions'** to those specified situations. Such an approach has an advantage of minimising the effect on practice.

73. [Paragraph omitted from observer note].

74. [Paragraph omitted from observer note].

75. This approach to providing guidance on what can be designated as a hedged portion is rules rather than principles based and would not lead to convergence with US GAAP.

76. However, this approach has a number of advantages:

- It places effective restrictions on eligible portions ensuring that the situations in which ineffectiveness exists but was not recognised because of a rather loose notion of a portion;
- Limiting the use of portions to those situations that are commonly used in practice will ensure that the impact on practice of any amendment is minimised;
- The situations in which an entity can hedge a portion of a financial instrument are clearly defined making application of the hedge accounting requirements simpler;
- Such an amendment would be relatively simple to implement requiring only small changes to IAS 39. Consequently, this approach is unlikely to need significant staff or Board time to develop.

STAFF RECOMMENDATIONS

Issue 1: When all of the cash flows of the entire financial instrument are hedged for one or more specific risks, should IAS 39 specify the risks that are eligible for hedge accounting?

77. The staff recommend View 1 (to specify the eligible risks).

78. [Paragraph omitted from observer note].

79. As mentioned earlier in this paper, all of the cash flows of the entire financial instrument can be hedged for one of the above-mentioned risks (or for a combination of one or more of the above-mentioned risks).

80. If the Board decide to specify the eligible risks (View 1), then the Board need to consider what '**other portions**' of the financial instrument associated with those risks can be designated as hedged items under Issue 2.

81. Alternatively, if the Board decide not to specify the eligible risks (View 2), the Board will need to specify the risks in Issue 2 when the Board identifies what portions of a financial instrument can be designated as hedged items.

Issue 2: What 'other portions' of a financial instrument are eligible to be designated as hedged items?

82. The staff recommend Approach 4 (to specify '**other portions**'). If the Board decide to specify the eligible risks in Issue 1, then it will need to consider what **'other portions'** of the financial instrument associated with those risks can be designated as hedged items.

83. Alternatively, if the Board decide not to specify the eligible risks in Issue 1, it will need to specify the risks when the Board identifies what '**other portions**' of a financial instrument can be designated as hedged items. [Sentence omitted from observer note].

84. The above-mentioned portions are eligible to be designated as hedged items, subject to the requirement in AG 99C of IAS 39, which requires that the cash flows of a hedged portion should not be greater than the total cash flows of the financial instrument.

85. The staff believe that Approach 4 would clarify and simplify the hedge accounting requirements without involving significant staff or Board resources. [Sentences omitted from observer note].

Summary of the effect of the staff recommendations

The table below summaries possible hedged exposures before and after the proposed amendments. It focuses on cases where financial instruments are designated as hedged items. [The following table omitted from observer note].

QUESTIONS FOR THE BOARD

Issue 1: When all of the cash flows of a financial instrument are hedged for one or more specific risks, should IAS 39 specify the risks that are eligible for hedge accounting?

86. Which of the two views set out in this paper does the Board wish to take? If the Board does not wish to take one of these views, what other approach does the Board wish to take?

87. If the Board wish to take View 1, which risks should be eligible?

Issue 2: What 'other portions' of a financial instrument are eligible to be designated as hedged items for hedge accounting?

88. Which of approaches 1 to 4 set out in this paper does the Board wish to take? If the Board does not wish to take one of these approaches, what other approach does the Board wish to take?

POSSIBLE PROCESS FOR THE PROPOSED AMENDMENT

89. If the Board agree with the staff's recommendation to amend IAS 39, it should consider how to develop the proposed amendments.

90. These issues have been outstanding for some period of time, and the staff consider that any guidance should be issued sooner rather than later to help shape the development of practice in this area.

Involvement of the IFRIC

91. This issue has been extensively debated by the IFRIC, and the Board could request that the IFRIC take the lead in developing the proposed amendment. However, given the heavy workload of the IFRIC in other areas, and the fact that the Board will have

to consider the amendment anyway, the staff recommend that the Board should develop the proposed amendment directly.

Stand-alone project or through the Annual Improvements Process?

92. The staff also recommend that the proposed amendment should be dealt with as a stand-alone amendment and not through the Board's Annual Improvements Process.

93. The Board's Annual Improvements Progress aims to address non-urgent, minor amendments to IFRSs (these amendments often emerge via recommendations from the IFRIC). Such amendments will focus on areas of inconsistency in standards or where clarification of wording is required.

94. The first omnibus exposure draft of the Annual Improvements Process is expected to be issued on 1 October 2007 with amendments effective 1 January 2009. To expedite the proposed amendment, the staff recommend that it be dealt with outside of the Annual Improvements Process.

95. In developing the proposed amendment, the staff would also propose to seek the views of some Financial Instruments Working Group members.

96. **Does the Board agree that the proposed amendment (a) should be developed directly by the Board, (b) as a standalone amendment, and (c) that in developing the proposed amendment the staff should seek the views of some FIWG members?**

Appendix 1 - Summary of the Approaches Available to the Board

Approach	Effectively restricts the use of portions?	Consistency with long term objective	Impact on practice	Resource requirements	Moves towards convergence?
1 - Abolish ‘other **portions’**	Yes	Yes - would simplify hedge accounting requirements.	Significant	Moderate	Partial
2 - Develop a principle for ‘other portions’	Depends upon principle	Probably would not simplify hedge accounting requirements.	Impact would depend upon the principle identified	Significant	No
3 - Converge with US GAAP	Yes	No	Significant	Moderate	Yes
4 - Specify ‘other portions’	Yes	Yes - would simplify and clarify hedge accounting requirements.	Limited	Limited	No