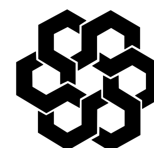

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International Accounting Standards Board

This document is provided as a convenience to observers at Financial Instruments Working Group meetings, to assist them in following the discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff paper prepared for the Financial Instruments Working Group Meetings. Paragraph numbers correspond to paragraph numbers used in the Financial Instruments paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB Meeting:	**Financial Instruments Working Group**
Paper:	**Agenda Paper 4**

IAS 39 *Financial Instruments: Recognition and Measurement* Identification of 'other portions' of an exposure eligible for hedge accounting

Introduction

1. At its December 2006 meeting, the Board decided to propose an amendment to IAS 39 (i) to specify the risks that qualify for designation as a hedged risk; and (ii) to provide additional guidance on what can be designated as a hedged portion in a hedging relationship.

2. The aim of the proposed amendment is not to significantly change existing practice regarding what can be designated as a hedged item under IAS 39; rather the purpose of the proposed amendment is to clarify the Board's original intentions regarding what can and what cannot be designated. Therefore the Board instructed the staff to carry out further research to determine the effect that the proposed amendments would have on existing practice.

3. The purpose of this paper is to inform members of the FIWG about the proposed amendment and seek feedback on the effect that the proposed amendment may have on existing practice.

Structure of paper

4. This paper has three sections. The first section provides background to the issue that the Board is attempting to address, and summarises the discussions of the IFRIC and the IASB. The second section of the paper explains the proposed amendment. The final section sets out a number of questions for FIWG members.

Background

IFRIC Discussions regarding an eligible hedged portion

5. The IFRIC received a number of submissions requesting guidance on what can be designated as a hedged portion under IAS 39. For example, the IFRIC was asked whether inflation could be designated as a hedged portion of an interest bearing asset or liability.

6. Rather than dealing with these submissions on a case-by-case basis the IFRIC attempted to develop a principle that could be used to produce guidance on what can be designated as a hedged portion under IAS 39.

7. However, the IFRIC concluded that the requirements of IAS 39 in this area were unclear. Consequently, the IFRIC were unable to develop a principle for providing guidance on what can be designated as a hedged portion. At its July 2006 meeting, the IFRIC asked the staff to approach the Board for guidance on how to address this issue.

8. At its October 2006 meeting, the Board acknowledged that additional guidance regarding the designation of hedged items is required.

What can be designated as a hedged item under IAS 39?

9. This paper (and the Board's proposed amendment) only focuses on situations in which a financial instrument or some part of a financial instrument is designated as a hedged item. This paper does not discuss situations where a non-financial item is designated as a hedged item. In addition, this paper does not address whether a financial instrument in its entirety can be designated as a hedged item. IAS 39 clearly allows a financial instrument in its entirety to be designated as a hedged item.

10. IAS 39 allows an entity to hedge all of the cash flows of an entire financial instrument for one or more specified risks. However, IAS 39 does not specify what risks are eligible for hedge accounting. IAS 39 only states that hedged risks must be identifiable and separately measurable. The first part of the Board's proposed amendment would involve specifically identifying the risks that are eligible for hedge accounting.

11. Where a hedged item is a financial instrument, paragraph 81 of IAS 39 permits an entity to designate as a hedged item the risks associated with only a portion of its cash flows or fair value provided effectiveness can be measured. For the purpose of this paper, an entity designates a 'portion' of a financial instrument other than when it designates:

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

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

(a) the future cash flows of a 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.

13. The portions described in bullet points (a) and (b) above are self-explanatory and are clearly permitted by IAS 39. In addition, 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).

14. 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).

15. Therefore, the second part of the amendment proposed by the Board is to clarify what ‘**other portions**’ of a financial instrument are eligible for designation.[1]

Board discussions

16. A number of proposals regarding the form and content of any additional guidance were discussed at the December 2006 meeting.

17. The Board first considered whether to amend IAS 39 to specify the risks that qualify for designation as a hedged risk under IAS 39. The Board concluded that specifying eligible risks would help clarify the Board’s original intentions regarding what can be designated as a hedged item. Consequently, the Board decided to propose an amendment to IAS 39 to specify the eligible risks.

18. The Board then discussed four possible approaches to providing guidance on what can be designated as an ‘other portion’ under IAS 39, namely:

- Approach 1 – Remove the ability to hedge a portion of a financial instrument (“Abolish **other portions**”);

[1] 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.

- 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**”).

19. In assessing the advantages and disadvantages of these approaches, the Board 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[2] – 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?
    - 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[3]?

20. The Board has tentatively decided to adopt approach 4 described above. That is, the Board has tentatively decided to amend IAS 39 to restrict the use of ‘other portions to specified situations. It was concluded that the risks eligible for designation as a hedged item would form the basis for the identification of ‘**other portions**’.

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[2] 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.

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

21. A more detailed description of the Board's proposals is provided in the next section.

Proposed amendment

Specifying risks eligible for hedge accounting

22. 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 the 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.

23. The Board concluded that the lack of guidance in this area is very likely to lead to requests for Interpretations in the future. Consequently, the Board decided to specify the risks that are eligible for designation as hedged risks.

24. The Board noted that 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[4] (or a combination of one or more of these risks).

[4] 'Credit risk' refers to the risk of changes in the fair value of a financial instrument attributable to both changes in the obligor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (see paragraph 21(f) of Statement 133).

25. The Board also noted that IAS 39 permits prepayment risk to be designated as a hedged risk[5] (though IAS 39 does not allow a held-to-maturity investment to be designated as a hedged item with respect to prepayment risk). Under the Fair Value Macro Hedging Model for interest rate risk, an entity is also permitted to hedge prepayment risk separate from interest rate risk (see paragraphs BC203 and BC204 of IAS 39). Although US GAAP does not separate prepayment risk from interest rate risk, it does allow a hedged item to be defined as the prepayment option component of a prepayable instrument. Consequently, the Board concluded that prepayment risk should be one of the eligible risks.

26. The Board also concluded that 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) should be eligible for designation.

27. 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.

28. 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.

29. In summary the Board concluded that the risks eligible for designation as hedged risks should be restricted to the following:

- Market interest rate risk;
- Foreign currency risk;
- Credit risk;

[5] IAS 39.79 states: '…. a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk…'

- Prepayment risk; and
- The risks associated with the cash flows of a financial instrument that are contractually specified and are independent from the other cash flows of the same financial instrument.

30. The Board acknowledged that this approach is rule rather than principle based. However, the Board believes it will provide clear guidance and remove the possibility of future requests for Interpretations in this area.

Specifying 'other portions'

31. As noted above, the Board decided to amend IAS 39 to restrict the use of '**other portions**' to certain specified situations. It was concluded that the eligible risks specified above would form the basis of the identification of the eligible '**other portions**'.

32. It is therefore proposed that an entity's ability to designate an '**other portion**' of a financial instrument as a hedged item be restricted to the following situations:

    - Hedging the risk-free or LIBOR portion of an interest bearing financial instrument. Risk free and LIBOR portions were selected as the Board understands that these are the interest rate portions that are most commonly hedged in practice;
    - Hedging the prepayment portion of an interest bearing financial instrument;
    - Hedging the remaining portion of an interest bearing financial instrument once the interest rate or prepayment risk portion has been excluded (labelled as a 'credit portion').

Questions for FIWG members

33. The staff welcome comments from FIWG members on the following questions:

- **Are the risks set out in paragraph 29 those risks most commonly hedged in practice? Do you believe that any other risks that should be eligible for designation as a hedged risk? If so, why?**
- **Are the 'other portions' listed in paragraph 32 the portions that are most commonly designated as hedged portions in practice? Are there any other portions the Board should consider? If so, why?**
- **Would the proposed amendments result in a significant change to existing practice? If so, what would those changes be?**