Project **Tentative agenda decisions**

Topic **Hedging using more than one derivative as the hedging instrument**

Background

1. In March 2009 the IFRIC received a request for guidance on how to apply IAS 39 Guidance on Implementing F.2.1 *Whether a derivative can be designated as a hedged item* (IAS 39 IG F.2.1.) when an entity issues fixed interest rate foreign currency debt and then swaps it into floating interest rate local currency debt using a cross currency interest rate swap (CCIRS). The entity also enters into a local currency pay-fixed, receive-variable interest rate swap (IRS), which has a shorter duration than that of the cross currency interest rate swap.

2. The fact pattern of the submission is summarised as a diagram in Appendix A.

3. Portions of the original submission (including supplementary information) are included as Appendix B.

4. The primary features of the arrangement are as follows:

   (a) an entity issues fixed interest rate foreign currency debt

   (b) the entity enters into a CCIRS (which has same duration as the foreign currency debt)

   (c) the entity enters into an IRS (which has a shorter duration than that of the CCIRS; the entity also intends to enter into a new IRS once the previous IRS expires).

5. The submission asks whether IAS 39 IG F.2.1 prevents the hedged cash flow in a hedge relationship being cash flows attributable to a derivative.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in *IFRIC Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in *IASB Update*.

Summary of alternatives outlined in the submission

6. In the submitter's example, the proposed hedging relationship at the inception of the debt is summarised as follows:

   (a) fair value hedge of the benchmark 10 years US debt for interest rate risk <hedging instrument is the full term of the 10 years CCIRS>

   (b) cash flow hedge for FX risk
   <hedging instrument is the full term of the 10 years CCIRS>

   (c) **a cash flow hedge of the 5 year AUD floating interest exposure**
   <hedging instrument is the full term of the 5 years IRS>
   At the end of the five year period the new IRS is designated into a new cash flow hedge of AUD floating interest exposure.

7. The submission contains two alternative views on the application of IAS 39 IG F.2.1:

   View A - IAS 39 F.2.1 **does not** prevent the hedged cash flow in a hedge relationship being cash flows attributable to a derivative. This view is that, provided the hedged item is linked back to a non-derivative financial item, the combination is not prohibited even if for the purposes of one of the hedge relationships the hedged risk is attributable to cash flows from a derivative. In the submitter's example, **the hedging designation (c) is permitted.**

   View B - IAS 39 F.2.1 **does** prevent the hedged cash flow in a hedge relationship being cash flows attributable to a derivative. In the submitter's example, **the hedging designation (c) is not permitted in respect of either the initial IRS or any subsequent ones because such designation is not eligible in accordance with IAS 39 (see paragraph 15).**

8. The supporters of View A think:
   "This relationship has been accepted … on the basis that all cash flows are linked as a combination to the underlying debt instrument. Provided all the derivatives are designated in a relationship that links back to the underlying debt instrument and the hedge relationships are effective at all times, the individual cash flows upon which each hedge relationship is assessed for effectiveness **should not result in a breach of F2.1**. It is argued that the three hedge relationships combine to hedge the individual risks associated with the foreign

currency debt. They further contend that over time as each new IRS is added to the combination it can be matched to a new hypothetical that is added concurrently to assess the effectiveness of the combination. As the hypothetical would mirror the actual IRS the combination works with minor ineffectiveness. The argument for adding future IRS is justified based on the rollover strategy which is contemplated as part of the original hedge strategy." [emphasis added]

9. The supporters of View B think:

   "Others are of the opinion that the second cash flow hedge ((c) above) relationship, when assessed on its own, **breaches F2.1** as the AUD interest rate exposure relates to one of the cash flows from the CCIRS which is a derivative instrument. **This has the practical implication that as each new IRS is added, the hypothetical cash flow hedges (b) and (c) must be reset, which in practice means the hedge relationship will no longer pass effectiveness tests.**" [emphasis added]

10. Views A and B are based on a different understanding of IAS 39 paragraph 77:

    Rationale for View A - Paragraph 77 of IAS 39 allows two derivatives to be **separately designated** when they are viewed in combination as the hedging instrument.

    Rationale for View B- Paragraph 77 of IAS 39 requires two derivatives to be **jointly designated** when they are viewed in combination as the hedging instrument.

11. The supporters of View A think:

    "the IRS [can] be viewed in combination **but designated separately** from the CCIRS, i.e. the CCIRS continues in the existing hedge relationship and the subsequent IRSs are designated into the new hedge relationship (to hedge the existing loan and existing CCIRS in the subsequent five year periods). This means a separate hypothetical can be established for the IRS which will not disrupt the other hedge relationships as new IRSs are introduced in future periods." [emphasis added]

12. The supporters of View B think that, as combinations of derivatives are viewed as a single derivative, any new combinations in subsequent five year periods of a

new IRS and the existing CCIRS will require the CCIRS to be designated afresh with the new IRS into a new relationship. However, they think that **"the existing CCIRS is likely to have a fair value at the new designation date, which will impact the effectiveness of the hedge relationship even though the fair value at new designation date is not strictly attributable to the new hedge relationship. In practice, this will mean that such a hedge arrangement will not be possible"**. [emphasis added]

Staff analysis

13. The staff notes that paragraph 77 of IAS 39 states that "Two or more derivatives….may be viewed in combination **and jointly designated** as **the hedging instrument**, including when the risk(s) arising from some derivatives offset(s) those arising from others." BC215 states that "The Board decided to permit the **hedging instrument** to be a portfolio of derivatives containing offsetting risk positions for both individual and portfolio hedges."

14. From the wording of IAS 39, in the staff's view, it was not the Board's intention that two derivatives could be viewed in combination **but separately designated.** Consequently**,** the staff think that one derivative (eg. the CCIRS) is not allowed to continue in the existing hedge relationship and another derivative (eg. the subsequent IRSs) be designated into the new hedge relationship. In other words, in the staff's view, IAS 39 does not allow the "synthetic hedged item" created by one derivative (ie the combination of the CCIRS and the USD debt as synthetic floating interest AUD debt) to then become the hedged item of another derivative (eg use the IRS as a hedging instrument to hedge the synthetic floating interest AUD debt).

15. In the staff's view, the real question in the case is whether the combination of the two derivatives (ie the CCIRS and the IRS) as the hedging instrument satisfy the hedge effectiveness test (as required by IAS 39 including paragraph 88) for one hedged item (eg the US debt) for the risks (US$/AUD FX risk and fixed/float interest risk). In the staff's view:

(a) the CCIRS and the IRS in combination are eligible for joint designation as the hedging instrument in a hedging relationship with the fixed rate US$ debt as the hedged item;

(b) the challenge of such a designation is the hedge effectiveness testing (as pointed out by supporters of View B – see paragraph 9 above);

(c) if the prospective hedge effectiveness test (paragraphs 88(b) and AG105(a) of IAS 39) fails because of the challenge associated with this hedging relationship then the hedging relationship would not qualify for hedge accounting **from the outset, ie commencement of the initial IRS covering the first five years** (notwithstanding the eligibility for designation).

In the staff's opinion, IAS 39 provides clear guidance for the cases of combining the two derivatives as a single hedging instrument and its hedge effectiveness test (including the submitter's case). Therefore, in the staff's view, development of an interpretation would result in providing implementation guidance on paragraphs 77 and 88, rather than an interpretation.

Agenda criteria assessment

16. The staff's preliminary assessment of the agenda criteria is as follows:

(a) *Is the issue widespread and practical?*
Yes. In the staff's view, the issue could arise in many jurisdictions in which entities raise capital in foreign currencies.

(b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*
No. Although the submission indicates that there are some degrees of divergence in practice, the existing IAS 39 provides clear guidance for the cases of combining the two derivatives as a single hedging instrument and its hedge effectiveness test (including the submitter's case). Therefore, development of an interpretation would result in providing implementation guidance on paragraphs 77 and 88 of IAS 39, rather than an interpretation.

(c) *Would financial reporting be improved through elimination of the diversity?*
N/A the staff does not anticipate diversity in practice.

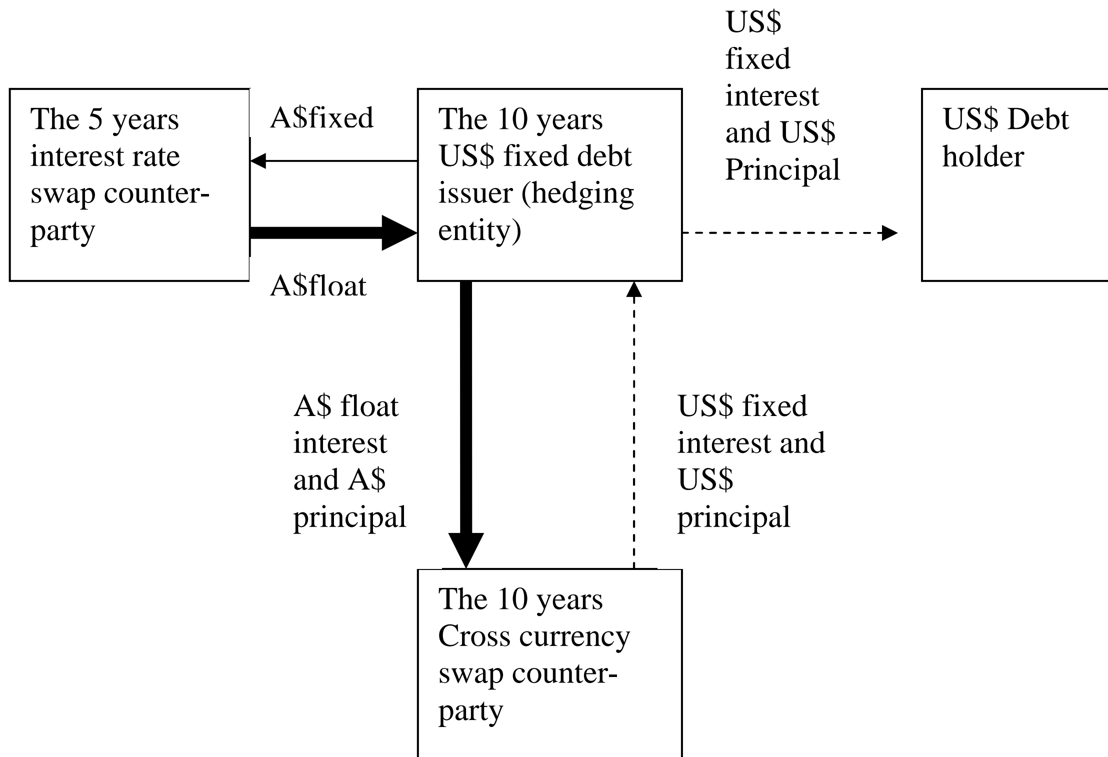
(d) *Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation*

and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?
No. The issue seems to be too narrow to develop an interpretation.

(e) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require to complete its due process.)*
The Board is accelerating its project Financial Instruments – recognition and measurement. However, it is not yet clear whether hedge accounting requirements will be revisited in the phase of the project that is expected to result in publishing an exposure draft in the fourth quarter of 2009.

Recommendation and question for the IFRIC
Based on the assessment of the agenda criteria in paragraph 16, the staff recommends that IFRIC not add the issue to its agenda. Wording for the proposed tentative agenda decision is set out in Appendix C. Does the IFRIC agree that the issue should not be added to the agenda? If not, on what basis should it be added? Does the IFRIC have any comments on the proposed wording for the tentative agenda decision?

Appendix A – a diagram describing the submitter's fact pattern



Appendix B – IFRIC Potential Agenda Item Request

The issue:

It is common for Australian companies to raise fixed interest rate foreign currency (FC) debt. The foreign currency debt is then swapped into floating interest rate local currency (LC) debt through a cross currency interest rate swap (CCIRS). The term of the CCIRS matches the term of the FC debt, which is usually between ten to twenty years. We raise foreign funds as the size of our funding requirement is too large for the Australian market.

In the regulated environment in which our industry operates, we are subject to regulatory resets on our revenue such that the revenue we receive is in part determined by the market interest rate that exists at the start of each five year reset period. To ensure our interest expense is in line with the interest rate used by the regulator when setting the revenue basis, we economically hedge the local interest exposure of the foreign debt by taking out a five year interest rate swap (IRS) which swaps out LC floating interest exposure into a LC fixed interest rate exposure. At the end of the five year period, when our revenue is reset by the regulator based on amongst other things, the LC interest rate at that date, we enter into a further five year IRS to lock in the LC interest rate exposure for a further five year period. We continue with this practice over the full term of the FC debt.

When applying hedge accounting there appear to be alternative views on the application of F 2.1 "WHETHER A DERIVATIVE CAN BE DESIGNATED AS A HEDGED ITEM."

- One view is that F 2.1 prevents the hedged cash flow in a hedge relationship being cash flows attributable to a derivative;
- The other view is that provided the hedged item is linked back to a non-derivative financial item, the combination is not prohibited even if for the purposes of the one of the hedge relationship the hedged risk is attributable to cash flows from a derivative.

The proposed hedging relationship that is the centre of the interpretation is as follows:

At the inception of the debt (which aligns with the inception of the CCIRS and the first IRS) the derivative instruments are designated in combination as a hedge of the following:

(a) fair value hedge of the benchmark US debt for interest rate risk <hedging instrument is the full term of the CCIRS>

(b) cash flow hedge for FX risk <hedging instrument is the full term of the CCIRS>

(c) a cash flow hedge of the 5 year LC floating interest exposure <hedging instrument is the full term of the IRS>

At the end of the five year period the new IRS is designated into a new cash flow hedge of LC floating interest exposure.

This relationship has been accepted by some on the basis that all cash flows are linked as a combination to the underlying debt instrument. Provided all the derivatives are designated in a relationship that links back to the underlying debt instrument and the hedge relationships are effective at all times, the individual cash flows upon which each hedge relationship is assessed for effectiveness should not result in a breach of F2.1. It is argued that the three hedge relationships combine to hedge the individual risks associated with the foreign currency debt. They further contend that over time as each new IRS is added to the combination it can be matched to a new hypothetical that is added concurrently to assess the effectiveness of the combination. As the hypothetical would mirror the actual IRS the combination works with minor ineffectiveness. The argument for adding future IRS is justified based on the rollover strategy which is contemplated as part of the original hedge strategy.

Others are of the opinion that the second cash flow hedge ((c) above) relationship, when assessed on its own, breaches F2.1 as the LC interest rate exposure relates to one of the cash flow from the CCIRS which is a derivative instrument. This has the practical implication that as each new IRS is added, the hypothetical cash flow hedges (b) and (c) must be reset, which in practice means the hedge relationship will no longer pass effectiveness tests. The solution proposed is to terminate the CCIRS and enter into a new CCIRS, which incurs significant economic and cash flow issues for no benefit.

<u>Current practice:</u>

In order to reduce accounting income statement volatility from the economic hedge, it is common practice to designate the derivative instruments into qualifying IAS 39 hedge relationships to the extent possible. Whilst some entities have designated these instruments into the qualifying hedge relationship discussed above, others such as ourselves have been refused this approach with the result that we forego hedge accounting and incur significant P&L volatility from the IRS.

<u>Reasons for the IFRIC to address the issue:</u>

(a) Is the issue widespread and practical?

This divergence in opinion is having a significant impact on the reported results of entities within revenue-regulated industries who all undertake similar economic hedge activities.

(b) Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?

Divergence in the interpretation of F2.1 allows some entities to obtain hedge accounting whilst disallowing others which has the potential for significant volatility.

(c) Would financial reporting be improved through elimination of the diversity?

Clarification of this issue would significantly enhance comparability between entities within the same industry. Furthermore, we believe there is an economic rationale behind the structure and if hedge accounting is not permitted due to a technical rule under the standard, that this rule should be consistently interpreted across an industry.

(d) Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?

The issue is limited to the interpretation of F2.1. Whilst the hedge relationship we have referred to may appear to be an isolated structure, the use of this structure is widespread and the interpretation may have benefit to other potential hedge relationships.

(e) If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require to complete its due process.)

Whilst the IASB is relooking at IAS 39 and considering alternative approaches to simplify the application of the standard, we believe that guidance in this area is required well in advance of the completion of this project. In addition, consideration of this issue will aid in the rectification of a practical issue facing many corporates.

Supplementary Information

Basis for hedge relationship

Hedged item

The hedged item is a financial liability. In accordance with IAS 39.81, this can be hedged in respect to risks associated with portions of its cash flows or fair value. The fair value of the financial liability is exposed to interest rate risk and the cash flows/fair value is also exposed to foreign exchange risk. Whilst the interest payable on the actual hedged item includes a credit margin above the risk free rate, for the purposes of simplifying the area of contention, assume that it bears interest at the benchmark interest rate.

Hedging instruments

The hedging instruments are a cross currency interest rate swap and a separate interest rate swap contracted with separate parties (both external to the reporting entity). As neither of the instruments are written options in accordance with IAS 39.72 they may be designated as qualifying hedging instruments

Hedge relationships

a) Fair value hedge of the benchmark US debt for interest rate risk
b) Cash flow hedge for FX risk
c) Cash flow hedge of the 5 year LC floating interest exposure

Relationship a) – meets the definition of a fair value hedge in accordance with IAS39.86(a) as it hedges the exposure to changes in fair value of a recognised liability, that is attributable to a particular risk (changes in the benchmark interest rate) and could affect profit or loss (I/s gain or loss if settled or transferred).

Relationship b) – meets the definition of a cash flow hedge in accordance with IAS39.86(b) as it hedges the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised liability (cash payment of interest and principal will fluctuate with changes in exchange rates) and (ii) could affect profit or loss (through IAS 21). The cash flow hedge relationship is further supported by IAS 39 IG F.3.3 FOREIGN CURRENCY HEDGE.

Relationship c) – meets the definition of a cash flow hedge in accordance with IAS39.86(b) as it hedges the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised liability (floating interest resulting from the combination of the financial liability and the CCIRS). The designation of this relationship is the area under debate as it potentially conflicts with IAS 39 IG F 2.1 “WHETHER A DERIVATIVE CAN BE DESIGNATED AS A HEDGED ITEM.”

When designating the hedging instruments: [the submitter considered the specific paragraphs of the standard and IG as follows.]

Paragraph 75 and F.2.17 PARTIAL TERM HEDGING

The CCIRS is being designated into relationship (a) and (b) such that it is designated for the full time period during which it remains outstanding.

The IRS is being designated into relationship (c) such that it is designated for the full time period during which it remains outstanding.

In relationship (c), the risk being hedged is a combination of the financial liability and the CCIRS. Whilst it is only hedging for a 5 year period, the combination hedge does not result in the CCIRS or the IRS being designated for a period less that full time period during which either instruments remain outstanding. Furthermore, F2.17 allows the hedged item in the relationship to be for a period less than it remains outstanding

Paragraph 76, F.1.13 HEDGING INSTRUMENT: DUAL FOREIGN CURRENCY FORWARD EXCHANGE CONTRACT and F.2.18 HEDGING INSTRUMENT: CROSS-CURRENCY INTEREST RATE SWAP

The CCIRS has been designated as a hedge of more than one risk. In relationship (a) it is hedging the fair value risk of the financial liability attributable to changes in benchmark interest rates whereas in relationship (b) it is hedging cash flow risks attributable to the fact that the interest and principal on the financial liability are to be paid in a currency other than the reporting entities functional currency. In respect of these two risks, we are able to demonstrate and have through our hedge documentation shown that (a) the risks hedged can be identified clearly; (b) the effectiveness of the hedge can be demonstrated; and (c) it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

The IRS has been designated as a hedge of only interest rate risk.

Paragraph 77

In relationship (a) and (b) a single CCIRS is used as the hedging instrument.

In relationship (c) the IRS is not being combined and designated as a single joint combination instrument (with the CCIRS) which is jointly designated as the hedging instrument but rather they have been designated such that the IRS is hedging the financial liability plus the CCIRS which all combined form the hedge relationship. This is in compliance with Paragraph 77 which states that derivatives can be "...viewed in combination and jointly designated as a hedge relationship."

The interpretation of paragraph 77 and IAS 39 IG F 2.1 “WHETHER A DERIVATIVE CAN BE DESIGNATED AS A HEDGED ITEM is the area of debate. When designating two derivatives together do they need to be designated as a single combination or can they be viewed in combination?

If combinations must be viewed as a single derivative, any new combinations in subsequent five year periods of new IRS and the existing CCIRS will require that the CCIRS needs to be designated afresh with the new IRS into a new relationship. However, the existing CCIRS is likely to have a fair value at the new designation date, which will impact the effectiveness of the hedge relationship even though the fair value at new designation date is not strictly attributable to the new hedge relationship. In practice, this will mean that such a hedge arrangement will not be possible.

Alternatively, can the IRS be viewed in combination but designated separately from the CCIRS, i.e. the CCIRS continues in the existing hedge relationship and the subsequent IRSs are designated into the new hedge relationship (to hedge the existing loan and existing CCIRS in the subsequent five year periods). This means a separate hypothetical can be established for the IRS which will not disrupt the other hedge relationships as new IRSs are introduced in future periods.

This latter relationship has been accepted by some on the basis that all cash flows are linked to the underlying debt instrument. Provided all the derivatives are designated in

a relationship that links back the underlying debt instrument and the hedge relationships are effective at all times, the individual cash flows upon which each hedge relationship is assessed for effectiveness should not result in a breach of F2.1. Others are of the opinion that the second cash flow hedge relationship when assessed on its own breaches F2.1 as the LC interest rate exposure relates to one of the cash flow from the CCIRS which is a derivative instrument.

F.1.14 CONCURRENT OFFSETTING SWAPS AND USE OF ONE AS A HEDGING INSTRUMENT

The IRS and the CCIRS are not entered into with the same counterparty and there is a substantive business purpose for structuring the transaction separately so F1.14 does not apply.

[Appendix C has been omitted from this Observer note]