



Project	Financial Instruments – Phase 3 Hedge accounting
Topic	Eligibility of financial instruments managed on a contractual cash flow basis in a fair value hedge

Introduction

Background

1. At previous Board discussions on hedge accounting¹, the appropriateness of the eligibility of fair value hedges for hedge accounting was questioned for items measured at amortised cost under the proposed classification model. The issue was whether managing an item on a ‘contractual cash flow basis’² could be consistent with designating that item as the hedged item for accounting purposes when the type of hedging relationship is a fair value hedge.
2. This paper only addresses the *eligibility* of fair value hedges for hedge accounting. Consistent with the Board’s tentative decision at its September meeting, if these fair value hedges qualify for hedge accounting cash flow hedge mechanics would be applied.

Purpose of the paper

3. **The objective of this paper is to discuss whether any items measured at amortised cost still qualify for fair value hedge accounting.**

¹ Agenda paper 15 of the September 2009 IASB meeting and Agenda paper 11 of the 6 October 2009 IASB meeting.

² The Board discussed the wording of ‘managed on a contractual yield basis’ and tentatively decided on the wording ‘the objective of the business model is to hold the instrument to collect (or pay) contractual cash flows rather than to sell (or settle) the instruments prior to their contractual maturity to realise fair value changes’. For simplicity, the wording of ‘managed on a contractual cash flow basis’ is used.

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

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

IASB Staff paper

4. If the Board concludes that no hedged item (of a fair value hedge) that is ‘managed on a contractual cash flow basis’ qualifies for hedge accounting there will be a knock-on effect on the fair value option.³

The issue

5. Some Board members believe that if financial instruments are measured at amortised cost they should not be eligible hedged items of a fair value hedge. These Board members argue that the ‘managed on a contractual cash flow basis’ condition implies that the objective of the entity’s business model is to hold the financial instruments to collect (or pay) contractual cash flows rather than to sell (or settle/transfer) the instruments prior to their contractual maturity to realise fair value changes. According to those Board members the entity is *only* interested in the contractual cash flows arising from these instruments and *not* changes in fair value. It follows that the entity should not be concerned about fair value changes arising from the instrument as they will not affect the contractual cash flows.⁴ A desire to enter into a fair value hedge is seen as calling into question that the instrument is ‘managed on a contractual cash flow basis’.
6. The staff thinks this rationale is similar to that of an existing restriction in IAS 39.79. In accordance with IAS 39.79, a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk because an investment classified as held to maturity requires an intention to hold the investment until maturity *without regard to changes in the fair value or cash flows* of such an investment attributable to changes in interest rates⁵.

³ The Board tentatively decided that the fair value option would only be available to eliminate or significantly reduce an accounting mismatch.

⁴ Except fair value changes attributable to credit losses.

⁵ However, IAS 39.79 states that a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.

IASB Staff paper

7. It is not clear from the discussions at previous meetings whether the concerns expressed solely relate to fair value hedges of interest rate risk or to all types of fair value hedges. We assume these concerns are limited to hedges of interest rate risk because credit risk and foreign exchange risk affect cash flows that are collected, or collected or paid as expressed in the functional currency of the entity, respectively.

Staff analysis

8. It is important to note that the objective of hedge accounting is to provide a link between items in the financial statements and an entity's risk management activities including the effectiveness of those risk management activities.
9. The staff thinks that in assessing whether financial instruments that are 'managed on a contractual cash flow basis'⁶ should be eligible hedged items in a fair value hedge of interest rate risk⁷ there are two questions to consider:
- (a) Does fair value hedge accounting of financial instruments contradict a classification condition that employs a concept of 'managing on a contractual cash flow basis' (as suggested by some Board members)?
 - (b) Further, are there situations where it is appropriate to fair value hedge account for financial instruments that are managed on a contractual cash flow basis?

Does fair value hedge accounting for financial instruments contradict a classification condition that employs a concept of 'managing on a contractual cash flow basis'?

10. The staff thinks it is important to note that:
- (a) even if financial instruments are managed with the objective to collect (or pay) contractual cash flows it does *not* mean that the instruments are

⁶ For the remainder of this paper it is assumed the financial instruments discussed meet the 'basic loan feature' condition.

⁷ The remainder of this paper only addresses fair value hedges of *interest rate risk*.

IASB Staff paper

not exposed to fair value risk. In fact, a business model based on collection or payment increases exposure over time, as the entity does not intend (or in some cases is not in a position) to avoid fair value risks by transfer or settlement.

- (b) the ‘managed on a contractual cash flow’ condition does *not* prohibit the sale and transfer of financial instruments with basic loan features before maturity. There are no tainting rules like today in IAS 39.

11. In BC33 of the exposure draft *Financial Instruments: Classification and Measurement* the Board agreed that sales and transfers of financial instruments with basic loan features would not change the business model of the entity, as long as such transactions were consistent with managing the collection or payment of cash flows rather than realising changes in fair values. For example, an entity holds investments to collect their contractual cash flows but would sell the instrument if an entity needs to fund capital expenditures.
12. Hence, the staff does not think that fair value hedge accounting as such contradicts the classification condition of ‘managed on a contractual cash flow basis’ because:
 - (a) an entity remains exposed to fair value risk under a hold to collect (or pay) business model. In fact, *ceteris paribus* it is exposed to greater fair value risk because of its business model.⁸
 - (b) further, the fair value risk can potentially be realised for some of the instruments under a hold to collect (or pay) business model even if the objective is *not* to realise changes in fair value.
13. Hence, hedge accounting for fair value hedges is consistent with the ‘managed on a contractual cash flow basis’ condition because it reflects the possibility of sales (or early settlements/transfers) that are consistent with that classification condition.

⁸ A business model based on collection or payment increases that risk as management has less flexibility to mitigate the risks by transferring or settling the instrument (see paragraph 10(a) above).

IASB Staff paper

14. The staff notes that Board members that object to fair value hedge accounting for financial instruments managed on a contractual cash flow basis might, in essence, be disagreeing with the ‘managed on a contractual cash flow basis’ condition itself.
15. In addition, the staff thinks the notion of ‘held to maturity’ and ‘managed on a contractual cash flow basis’ are different. At the 29 September 2009 meeting, the Board decided not to include a requirement that an entity demonstrates that it holds a high proportion of similar instruments for long periods of time relative to their contractual terms. The Board agreed that this creates a line that is too close to a notion of held to maturity and will inevitably result in a ‘bright line’⁹. Hence, the staff does not think the rationale for prohibiting the hedging of interest rate risk and prepayment risk for held-to-maturity instruments applies to financial instruments managed on a contractual cash flow basis. The subset of financial instruments in question is different in nature.

Are there situations where it is appropriate to fair value hedge financial instruments that are managed on a contractual cash flow basis?

16. In the previous section, the staff has established that some financial instruments can be ‘managed on a contractual cash flow basis’ and still be exposed to fair value risks. The staff now considers whether there are situations where it is appropriate to fair value hedge an asset or an entire group of instruments that is managed on a contractual cash flow basis.
17. The staff notes that a common application of fair value hedge accounting is the conversion of the interest payments on fixed rate assets into variable rate interest payments using an interest rate swap.
18. An example. An entity wishes to invest in a particular credit quality variable rate asset. However, there are only fixed rate assets of the desired credit quality. The cash flow profile of a variable rate asset can be created buying the available

⁹ 29 September 2009 Agenda paper 3B.

IASB Staff paper

fixed rate investment and transforming the fixed interest cash flows from that asset into variable interest cash flows by way of an interest rate swap. There might be other reasons for such an investment approach as well. The focus of this investment approach (and the related hedges) is not necessarily to hedge the fair value exposure of the fixed rate asset but rather to generate and collect variable rate interest income.

19. Another example. An entity wants to raise long-dated funds for capital investment in the business. Given the underlying cash flow characteristics of the business, the entity wishes to pay a mix of variable and fixed interest rates on the funds raised. However, there is only significant investor demand for long-dated fixed rate assets of that issuer, and directly issuing variable-rate debt is not economical. Therefore entity issues a long-dated fixed rate bond, and then swaps some of the fixed-rate payments into variable rate payments to create the target mix of fixed and floating rate funding.
20. Another example. An entity originates and holds fixed rate loans. They are measured at amortised cost. The loan book is mainly funded by variable rate deposits. To protect itself against fluctuations in the interest margin due to changes in the variable funding rates the entity enters into a swap to pay away fixed interest and receive variable interest. The purpose of this hedge is not to manage the fair value exposure of the assets, but to manage the interest cash flows and achieve a target interest margin.¹⁰
21. The staff notes that (in all examples) an entity can continue to manage these instruments on a contractual cash flow basis. That is, the entity's objective is to receive or pay contractual cash flows on the asset or liability.
22. That is to say, the staff does not believe that fair value hedges are inconsistent with the 'managed on a contractual cash flow' condition.

¹⁰ The interest rate swap could also cash flow hedge the variable rate funding. However, the entity believes designating the fixed rate assets against its funding better reflects the way that the entity manages risk.

IASB Staff paper

Summary of staff analysis

23. In summary the staff thinks that:

- (a) hedge accounting for fair value hedges for instruments that are managed on a contractual cash flow basis does not contradict the classification condition.
- (b) there are situations where hedge accounting for fair value hedges for instruments that are managed on a contractual cash flow basis is appropriate and provides decision useful information.

Eligibility for hedge accounting of financial instruments that are managed on a contractual yield basis and hedged items in fair value hedges of interest rate risk

Does the Board agree with the staff analysis?