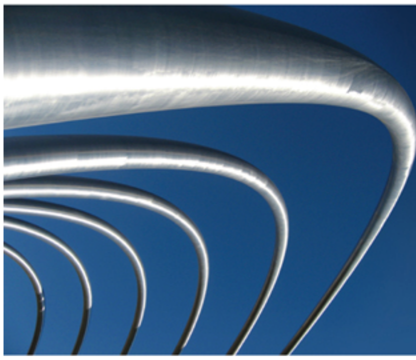
International Financial Reporting Standards



Hedge accounting

IASB/FASB JOINT MEETING

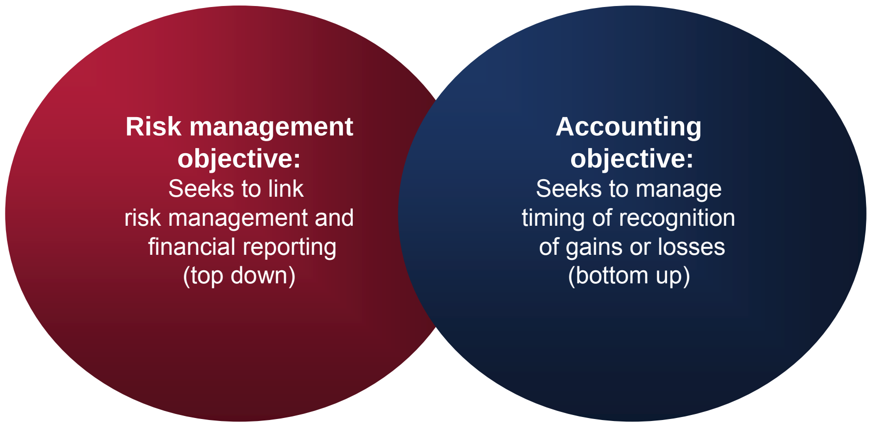
Week beginning 13 December 2010

Agenda paper 12

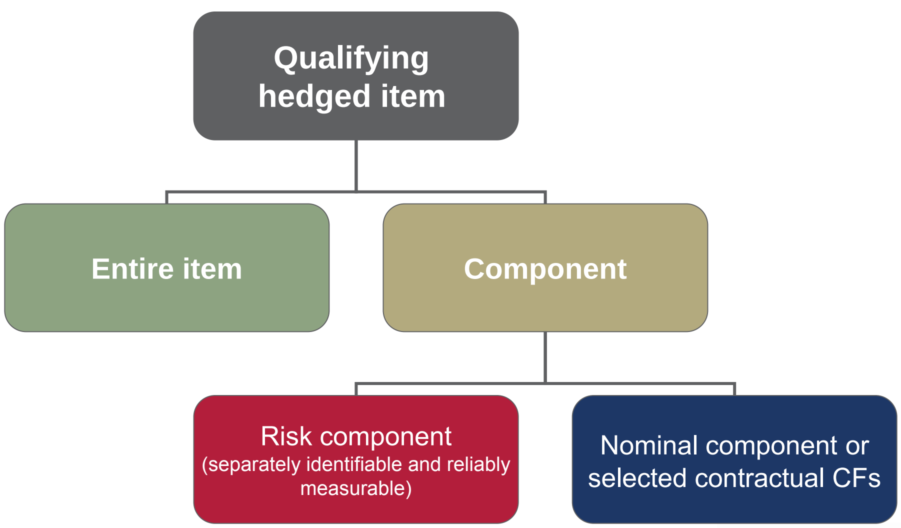
The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation

Components of the hedge accounting model

Objective



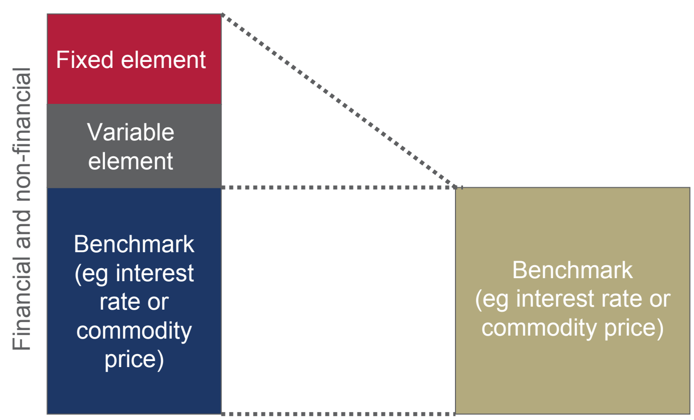
Hedged items



Hedged items: nominal components

- Proposals:
  - Two types of nominal components:
    - **Percentage component** (ie proportional to nominal amount of item)
    - **Layer component**
    - → Type affects accounting outcome
  - Layers eligible for groups of items and individual items
    - → Exception: if a prepayment option exists (unless the strike price is the fair value of the underlying)

Hedged items: risk components



Hedged items: risk components continued

7

- Proposals:
  - 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

Hedged items: aggregated exposures

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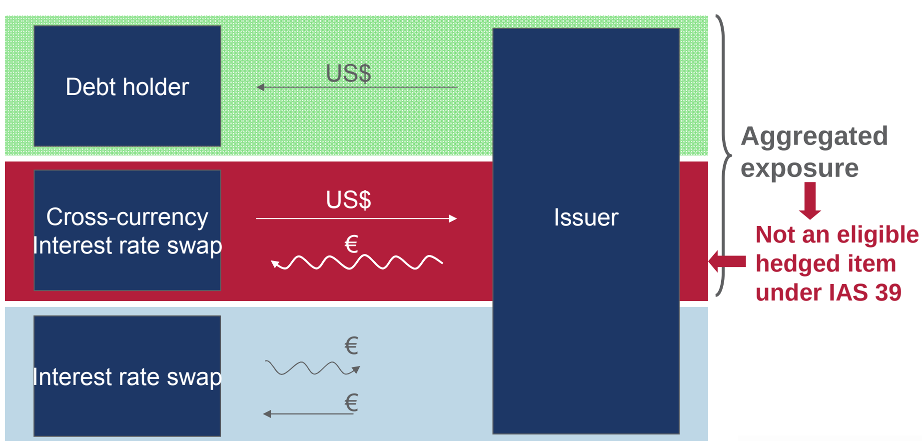
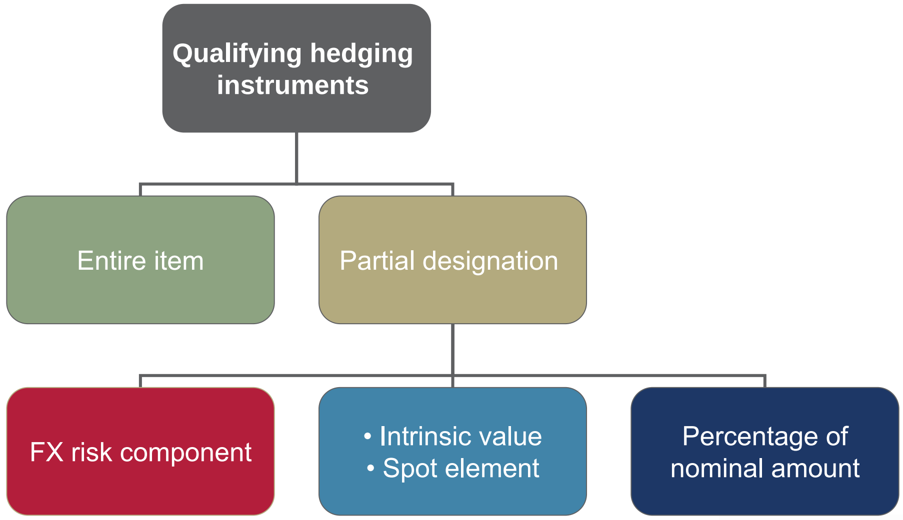
Aggregated exposure—combination of: (a) another exposure and (b) a derivative



Hedging instruments



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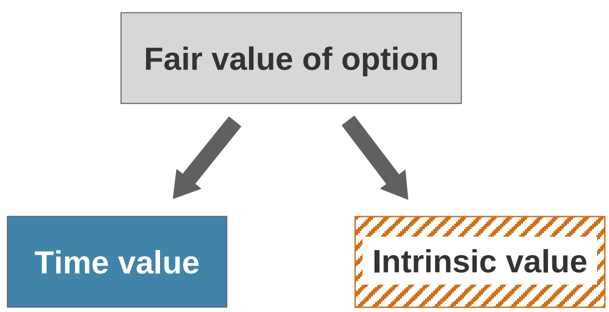
Hedging instruments: time value of options



→ Reflects probability of being in the money in the future

→ Always ≥ 0 (for option holder)

→ Value of being in the money

→ Is 0 if option is at or out of the money

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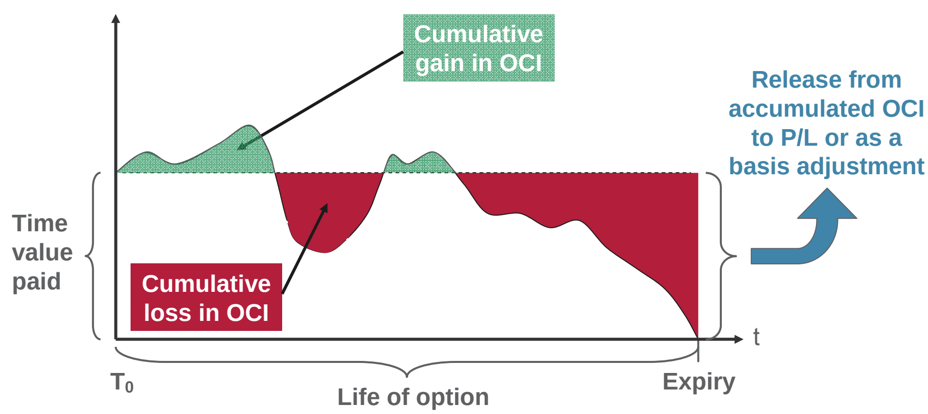
Time value of options

- Time value of options
  - Transaction related hedged item
  - Time period related hedged item

Option: time value continued

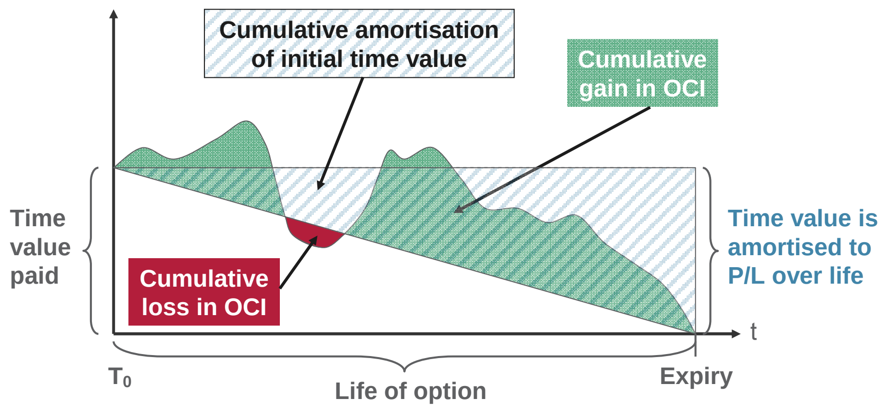
Accounting if the hedged item is <u>transaction related</u>



Treatment as a cost of hedging reflects economics

Option: time value continued

Accounting if the hedged item is time period related



Treatment as a cost of hedging reflects economics

Hedge effectiveness

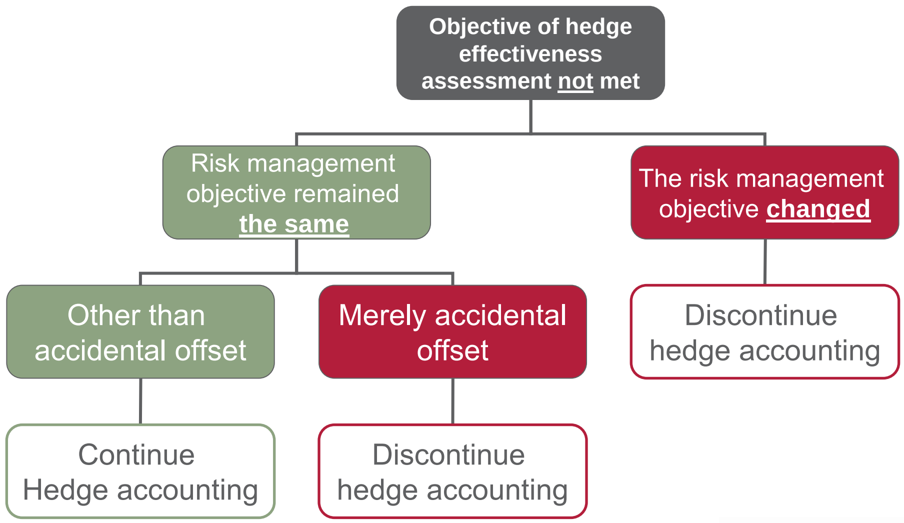
Hedge effectiveness

Hedge effectiveness requirements (qualifying criteria):

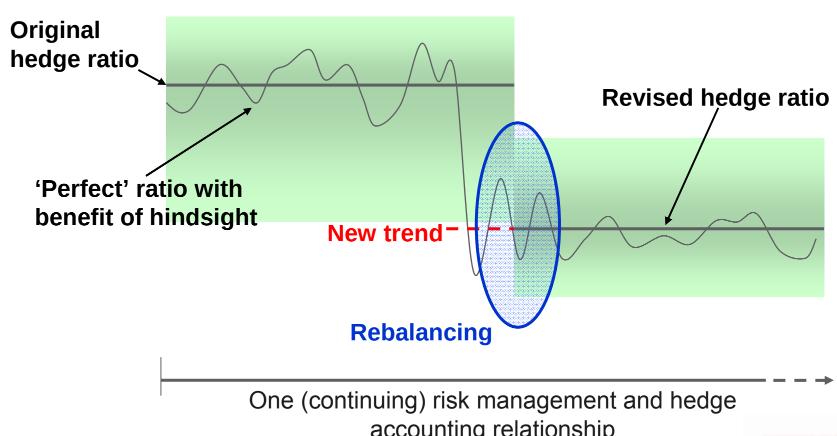
1. Objective of effectiveness assessment is met
2. More than accidental offset

Measuring and recognising hedge ineffectiveness

Discontinuation and rebalancing



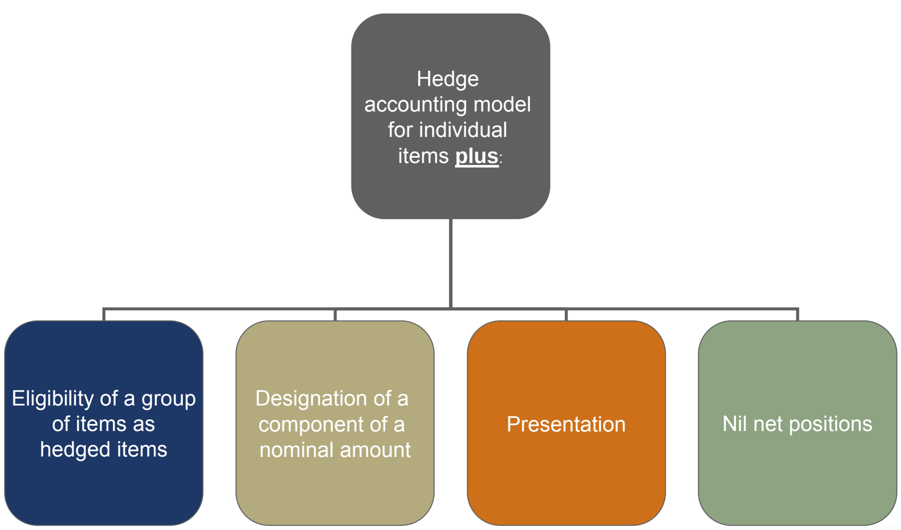
Effectiveness assessment continued



Recognise hedge ineffectiveness

- Proposals:
  - *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 (same for effectiveness assessment!)
    - One possible way to determine the change in value of the hedged item

Groups and net positions



Hedged items: groups and net positions

- 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 gains and losses)
    - groups that include income/expense items and assets/liabilities

Hedged items: groups and net positions continued

- Proposals:
  - Net positions as eligible hedged items:
    - Conditions:
      - Consistent with risk management
      - Items identified on a gross basis
    - √ Fair value hedges
    - √ Cash flow hedges:

      →Only if offsetting cash flows affect profit or loss (in their entirety) in the same period

Hedged items: groups and net positions continued

- Proposals:
  - 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
  - Separate line item presentation of hedging instrument gains or losses for net position hedges if group has offsetting risks
    - For example sales and purchases hedged for FX risk or interest revenue and expense

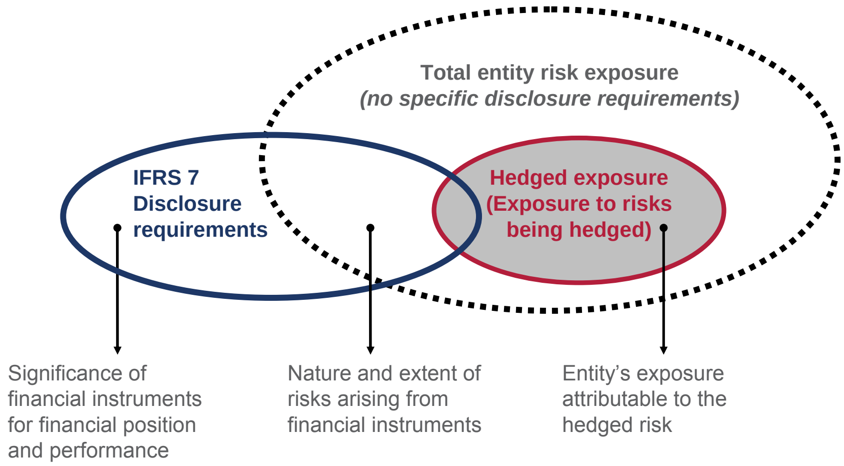
Presentation of fair value hedges

- Hedge Accounting in one place—OCI
- Transparency for hedging effectiveness and ineffectiveness
- Balance Sheet carrying amounts not adjusted

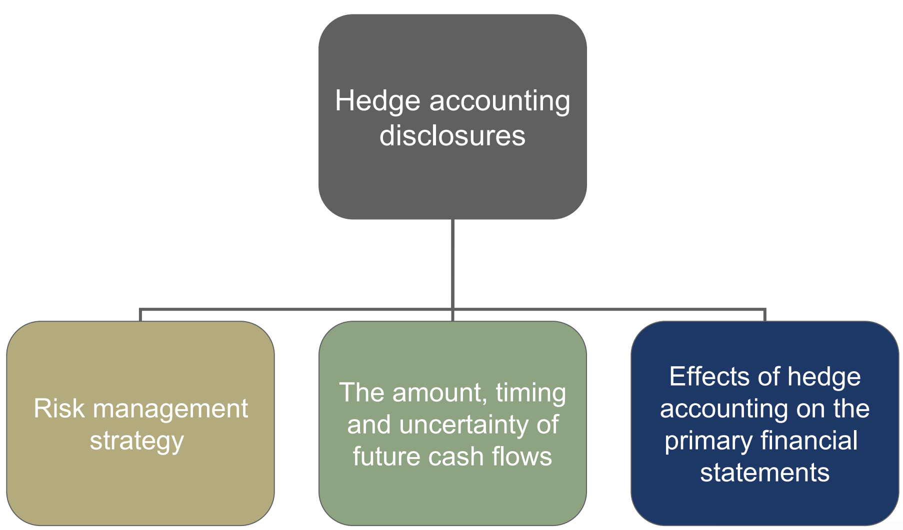
Comprehensive picture of hedge accounting effects in one place

Disclosures: scope

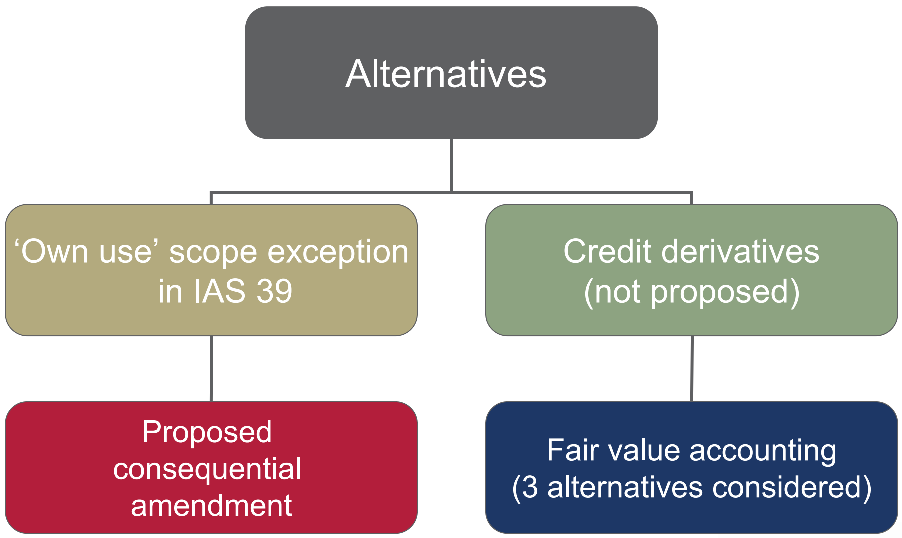
Proposed scope for hedge accounting disclosures



Disclosures proposed



Alternatives to hedge accounting



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Knock-on effects of other project phases

- Proposals:
  - **Embedded derivatives**
    - embedded derivatives are eligible hedging instruments only if separated from their host contract

      ⇒no longer available under IFRS 9 for asset host contracts
  - **Equity investments for which the OCI presentation alternative is elected**
    - hedge accounting is not available for instruments designated at fair value through OCI
  - **Impairment**
    - interaction of expected loss model with 'highly probable'

IFRS

Transition and effective date

- Proposals:
  - 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
    - all existing IFRS 9 requirements must be adopted at the same time (or already have been adopted)

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.