



17 February 2010

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Project	<b>Accounting for Financial Instruments – Hedge Accounting</b>
Topic	<b>Hedged items: Approach for determining what risk components are eligible for designation</b>

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## Introduction

### *Background*

1. At the 2 February 2010 meeting, the IASB tentatively decided to permit the designation of risk components as eligible hedged items (i.e. permit bifurcation-by-risk). At that meeting some IASB members noted that:
  - (a) this should not mean that an item could be componentised in any way at will; and
  - (b) designation of a component should not automatically result in a hedge accounting relationship being 100 percent effective.
2. This paper is written in response to the specific concerns raised by some IASB members and further explores criteria for the eligibility of risk components to be designated as hedged items. Therefore, this paper focuses on IAS 39 only.
3. At the same 2 February 2010 meeting, the FASB decided to explore bifurcation-by-risk and requested the staff to develop possible approaches. The FASB staff presents three approaches for FASB discussion in Agenda paper 9B. That agenda paper retains the eligible hedged risks as currently permitted in U.S. GAAP.

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

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at its public meetings are reported in a FASB *Action Alert* and an IASB *Update*. Official pronouncements of the FASB and the IASB are published only after they have completed their full due process, including appropriate public consultation and formal voting procedures.

**Purpose of this paper**

4. As directed by the IASB, this paper further explores criteria for the eligibility of risk components to be designated as hedged items set out in agenda paper 4C of the 2 February meeting i.e.:
  - (a) the risk component must be **separately identifiable** within the entire hedged item; and
  - (b) the effects of the identifiable risk component must be **measurable** for purposes of determining ineffectiveness.
5. This paper applies these criteria (in the following referred to as ‘the criteria’) to a set of examples, which demonstrates that:
  - (a) a principle-based bifurcation-by-risk approach is *not* a free choice of how to split an item into components; and
  - (b) that hedge ineffectiveness *can* result by designating components as hedged items.

However, the staff wishes to highlight that this paper is not about the mechanics of calculating hedge ineffectiveness. This will be addressed in a later paper.

6. The paper also highlights aspects of the criteria that warrant a review and sets out a staff recommendation for the next steps.

**Staff analysis**

***Experience with use of the criteria under IAS 39 for financial hedged items***

7. The staff notes that IAS 39 already uses essentially the same criteria with respect to *financial* hedged items.<sup>1</sup> The experience with applying IAS 39 has demonstrated that the criteria have worked in identifying eligible (and ineligible) hedged risk components of *financial* hedged items.

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<sup>1</sup> See IAS 39.81 and AG99F.

8. Before moving on to examples let us consider what makes a risk component identifiable and its effects measurable. In the staff's view there are two broad situations:

- (a) **the component is explicitly specified within the contract**, eg:
  - (i) the LIBOR interest component of a variable rate instrument based on LIBOR; or
  - (ii) the copper component within a contract for engines where the price of the overall contract includes a price element that is determined by reference to the copper price (price adjustment clause).<sup>2</sup>
- (b) **the component is not explicitly specified within the contract**, eg:
  - (i) the LIBOR interest component of a fixed rate instrument; or
  - (ii) the crude oil component in jet fuel.

***Contractually-specified risk component***

9. The staff notes that when the exposure relates to a variable that is contractually specified within the contract, the link is straight forward. Changes in the contractually specified variable will always affect the fair value or cash flow variability of the entire hedged item. Although there might be offsetting changes from other risks there is a clear relationship between the value changes of the risk component and the value changes of the entire item as the link clearly contributes to the overall change in fair value or cash flows.
10. For example changes in the LIBOR benchmark interest rate will always affect the cash flow variability of a variable rate instrument that is based on LIBOR. The risk component is separately identifiable within the entire instrument.

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<sup>2</sup> All references to non-financial hedged items are for illustrative purposes *only*. The staff notes that at the January 2010 and 2 February joint meetings the boards agreed to discuss issues relating to financial hedged items before considering non-financial hedged items. Hence, any decisions relating to this paper will apply *only* to financial hedged items.

Moreover, the effect of the change in LIBOR to the change in cash flow variability of the entire instrument can be easily measured.

***Non-contractually-specified risk components***

11. The staff notes that when the risk component is not contractually specified the link is not as evident as it is in the contractual link scenario. Hence, the staff has selected some scenarios to test the ‘separately identifiable’ and ‘measurable’ criteria.
12. The staff notes that when moving beyond contractually-specified risk components, other factors such as market structure, pricing methods, market participants’ views, where in the production process a product is (ie upstream or downstream) need to be considered when determining whether the criteria are met. Some form of judgment will be required under any principle-based approach to bifurcation-by-risk. The following illustrates how the criteria could be applied in the following scenarios.

*Interest rate risk*

13. Let us apply the criteria to a fixed-rate interest bearing financial instrument.

*Is the risk component separately identifiable within the entire hedged item?*

14. In the case of a fixed-rate instrument, the benchmark interest component is not contractually specified (the contractually-specified component is a fixed rate of interest eg 5%). However, for most interest bearing instruments there is a market structure that results in a known and separately measurable relationship between a change in the benchmark interest rate and the fair value of the fixed rate instrument. When pricing (valuing) such items at issuance or in secondary markets, market participants often use a building block approach and begin with the relevant interest rate swap curve or the relevant government bond rate curve. Also, market participants typically use the benchmark interest rate as a reference point in describing that part of the fair value change that reflects interest rate movements in the wider market rather than those due to individual factors that

affect a particular instrument. Such circumstances mean that the market interest rate is separately identifiable within the entire hedged item.

*Are the effects of the identifiable risk component measurable for purposes of determining ineffectiveness?*

15. Interest rates for different periods are observable in the market. The effects of changes in interest rates on the fair value or cash flow variability of a financial instrument can be readily determined.
16. However, the staff notes that this does not mean that all hedges of designated interest rate risk components will be perfectly effective. For example, an entity might designate an interest rate swap with a day count convention for interest accrual of actual/actual as a hedge of its fixed-rate borrowing with a day count convention of 30/360. Although the hedge is expected to be highly effective, the change in the fair value of the benchmark interest component of the borrowing is not perfectly offset by the change in the fair value of the interest rate swap because of differences in the day count conventions. Ineffectiveness arising from the differences in the day count conventions will be recognised immediately in profit or loss.

*Inflation risk*

17. Let us apply the criteria to a non-contractually specified inflation element of a fixed rate bond.

*Is the risk component separately identifiable within the entire hedged item?*

18. Expected inflation is traded in some markets like expected interest rates. There is theoretically a relationship between expected inflation, expected nominal interest rates and hence the fair value of a bond. However, for the purpose of applying IAS 39, the board came to the conclusion that there is not a clear enough relationship between the inflation index (which is calculated using many financial and non-financial inputs from across the whole economy) and the

inflation risk a specific fixed rate bond is subject to for an inflation component of the bond to be considered separately identifiable.<sup>3</sup>

*Are the effects of the identifiable risk component measurable for purposes of determining ineffectiveness?*

19. For the purpose of applying IAS 39 the board also concluded that any inflation element is not a reliably measurable component of the fixed rate bond.
20. However, as mentioned above, if the inflation component is a contractually specified component ie in an inflation-linked bond, the inflation component is generally separately identifiable and its effects on the fair value or cash flow variability of the entire bond are measurable. In this situation, the inflation component would be eligible for designation.

*Credit risk*

21. Let us apply the proposed criteria to the credit risk component of a fixed rate loan.

*Is the risk component separately identifiable within the entire hedged item?*

22. In pricing loans, creditors will require reimbursement for the credit risk they assume by providing resources to their debtors. Hence, the fair value of a financial instrument reflects the specific credit risk of a financial instrument.
23. However, in applying IAS 39 in practice the identification of a separate credit risk component has proven to be difficult. While this is an evolving area entities so far have mostly not succeeded in identifying a separate credit risk component in a cash instrument such as a bond or loan.

*Are the effects of the identifiable risk component measurable for purposes of determining ineffectiveness?*

24. Although it is evident that a credit risk element is present in (almost) any financial instrument, in practice it is difficult (if even possible) to determine in

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<sup>3</sup> That was the rationale for issuing *Eligible Hedged Items* (Amendment to IAS 39) in July 2008.

isolation the effects of credit risk on the fair value changes of a specific instrument. This is reflecting the difficulties already experienced in identifying a component. One of the key issues is that instruments that are frequently used to hedge credit risk (eg credit default swaps – CDSs) are not as closely aligned with the hedged cash instruments (eg bonds or loans) as in the case of benchmark interest rate risk. Factors contributing to this are for example the type of default events used in CDSs and the settlement mechanism for payouts on CDSs (eg auctions). Maturity mismatches between CDSs and the related cash instrument can amplify these problems.

### **Summary of staff analysis**

#### *Implication for the viability of a principles-based approach*

25. In summary, the staff analysis demonstrates that application of the criteria under IAS 39 does *not* result in *all* risk components being eligible for hedge accounting. The staff notes that:
  - (a) some risk components are both separately identifiable and their effects measurable (eg benchmark interest rate risk).
  - (b) some risk components are not be separately identifiable (eg inflation risk in fixed rate instruments).
  - (c) some risk components that might theoretically be separately identifiable and measurable are in practice difficult (if not impossible) to isolate (eg credit risk).
26. The staff analysis also demonstrates that even when a risk component is eligible for hedge accounting that is *not* tantamount to the hedging relationship being perfectly effective (like in the interest rate risk example).
27. Hence, there is empirical evidence from the application of IAS 39 to financial hedged items that *rebut*s concerns and assertions that a principles-based approach to bifurcation-by-risk:
  - (a) is a free choice of how to split an item into components; and

- (b) automatically results in no ineffectiveness being recognised in profit or loss.

***Implication for the development of criteria for eligibility of components***

28. Moreover, the staff analysis illustrates that when moving beyond contractually-specified risk components, other factors such as market structure, pricing, market participants' view and so on are relevant in determining the eligibility of risk components for designation as a hedged item.
29. It is impossible to specify within every scenario which risk components are eligible (and which are not) because of the differences in market structures, pricing methods, market participants' views and so on. Determination of eligible risk components will ultimately require judgment and an understanding of the context of the hedging relationship and the hedging strategy applied. Judgment will be required under any principles-based approach.
30. The staff notes that the IASB explored a rules-based approach to bifurcation-by-risk in its exposure draft *Exposures Qualifying for Hedge Accounting*. Respondents to that exposure draft noted that the proposed list was not comprehensive, and that any list never could be given different marketplaces that exist around the world. Almost all respondents also questioned the Board's rationale for permitting some risk components but not others. The staff believes that the board will ultimately encounter the same issues if the Board pursues a rules-based approach to the identification of eligible components.
31. Moreover, a rules-based approach is inconsistent with the IASB's goal to develop principles-based standards. In particular, such an approach would not be responsive to concerns raised by constituents over a long period of time.
32. The IASB staff's outreach and observations of existing practice highlight that preparers are generally able to apply the criteria. In fact confusion and complexity arises because the standard contains both principles and rules that are inconsistent with each other. For example, some question why a contractually-specified risk component of a non-financial item that is clearly identifiable and measurable is prohibited from hedge accounting. Moreover,



analysts that the staff has reached out to demonstrate an understanding of the specific risk components that are commonly hedged within the sectors they follow.

### Next steps and staff recommendation

33. The staff analysis used the experience with applying IAS 39's approach to determining risk components that are eligible for designation as financial hedged items in order to ascertain the viability of a principles-based approach. While the existing requirements of IAS 39 by and large worked in practice there are some aspects that warrant a review, for example:
- (a) the requirements include some rules that are arbitrary (see paragraph 32);
  - (b) the requirements are set out in a way that includes inconsistent<sup>4</sup> and possibly redundant aspects<sup>5</sup>;
  - (c) whether the structure of the criteria as a cumulative set of two criteria is logically sound (or whether for example 'identifiable' is a condition precedent of measurable rather than a separate criterion in itself);
  - (d) the design of the criteria with a sole view to financial hedged items (which is inconsistent with a principles-based approach to all hedged items irrespective of whether financial or non-financial).
34. Therefore, the IASB staff does not believe that the existing requirements of IAS 39 should simply be carried forward in a project that fundamentally revisits hedge accounting. **Consequently, the IASB staff recommends to explore a new criterion (or criteria) for the purpose of determining eligible hedged components.**

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<sup>4</sup> Eg the use of the attribute 'separately' sometimes for the 'identifiable' criterion (IAS 39.AG99F) and sometimes for 'measurable' criterion (IAS 39.81).

<sup>5</sup> Eg the use of the attribute 'separately' to qualify the aspects of identifiable or measurable.

**Question – Next steps for developing criteria for designation of risk components**

The staff recommends exploring a new criterion (or criteria) for the purpose of determining eligible hedged components.

Does the Board agree with the staff recommendation? If not, why not, what does the Board wish to do instead and why?