**IASB Meeting** Agenda reference **8B**

Staff Paper Date **January 2010**

Project **Phase 3 – Hedge Accounting**

Topic **Eligible hedged items – Components**

## Purpose of this paper

1. This is an introductory paper to a series of papers that addresses the eligibility of components[1] (ie an item that is a component part of but not the entire item) as hedged items. This paper does not include a staff recommendation or question to the Board.

2. The purpose of this paper is to:

   (a) provide an overview of the type of components that will be addressed in a series of papers; and

   (b) preview issues relating to the eligibility of components as hedged items in this series of papers.

   This paper is for education only. The staff does not intend to discuss this paper at the meeting.

## Background

### *Connection with the objective of hedge accounting*

3. The staff's outreach confirmed that risk management strategies that hedge items by risk-specific components are most common in practice. Hence, the issue of

[1] This series of papers uses the term 'component' to describe a hedged item that is not the entire item. These hedged items are also generically referred to as 'portions' in accounting literature (but not consistently).

what components can be hedged items in a hedging relationship for accounting purposes is relevant for the questions of how much risk management practice can be aligned with financial reporting.

### *What is a component?*

4. A hedged component is a hedged item that is something less than the entire item. Thus, a component reflects only some of the overall exposures that arise from the item.
5. The value of a hedged item typically results from different aspects. For example, the value of a financial instrument is a function of *amounts*, *timing* and *uncertainty* of cash flows. When an entire instrument is hedged, the total cash flow amounts over the entire life are hedged. Thus, the hedge covers all cash flow variability and/or fair value changes arising from all exposures of the instrument. However, when an instrument is componentised, one or more of these aspects (*amounts, timing, and uncertainty*) is not hedged in its entirety.

## What types of components are there?

6. As noted above, a hedged component is a hedged item that does not reflect the overall exposures that arise from the item. The most common hedged components today are:
   (a) proportions – something less than the total cash flow amounts from the instrument is hedged;
   (b) a specific hedged risk – something less than the total ‘uncertainty’ (risk) arising from the instrument is hedged;
   (c) a partial term hedge – a period of time less than the total duration of the exposure (eg a period to maturity) is hedged.
7. Appendix B sets out the various components that this series of papers will address. It is important to note that there are various permutations of components. The tree diagram sets out a comprehensive outline of the most

basic components (the building blocks of an instrument). All the lowest level components can be further combined. For example, an entity might hedge a percentage of the instrument for a specific risk arising from that instrument for only a specific period of time (a partial-term hedge of a proportion for a specific type of risk). An example is a hedge of 70% of the nominal amount of a 10-year loan for the benchmark interest rate risk of the first five years.

***Components of nominal amounts***

8. Components of nominal amounts relate to a specified part of the metric of the hedged item. For example:

   (a) 50% of the nominal value of a loan (ie a percentage of a contractual amount);

   (b) The first 100 barrels of the oil purchases in June 201X (ie a part of a physical transaction volume);

   (c) The next 10m cash flows from CHF-denominated sales after the first 20m in March 201X for an entity with EUR as its functional currency (ie part of a monetary transaction volume);

   (d) 50,000 cubic meters of the natural gas stored in location XYZ (ie part of a physical volume).

9. In these scenarios the entity hedges *some* part of the metric of the hedged item. That part can then be hedged for various aspects depending on the objective of risk management policy.

10. The staff notes the designation of components of nominal amounts as hedged items is usually relatively straight-forward as the components are typically clearly identifiable and measurable.

***Components of (the overall) risk***

11. One of the more problematic areas in designating components as hedged items relates to designation of components of risks. The designation of all risks

arising from an instrument is relatively straight forward as the entity hedges the entire overall exposure of the item. For example, an entity might hedge a five-year debt instrument it holds using a total return swap.

*Specific risk type*

12. Issues relating to components of risk arise when an entity only hedges *some* (but not all) risks. For example, an entity might hedge only the benchmark interest rate component of an interest bearing debt instrument or the crude oil component of a refined oil product.

*Time component – partial term hedge*

13. Moreover, an entity might hedge exposures arising from an instrument for part of its time until maturity (ie a time component). This is commonly referred to as a partial-term hedge. In this situation only some risks are hedged as only exposures arising within a specific period (not all exposures arising from the instrument) is hedged. For example, an entity might hedge the risk associated with changes in the benchmark interest rate for the first four years of a seven year bond.

*One-sided hedge*

14. In addition, an entity might hedge exposures arising from one-side of a risk. An entity might hedge exposure to a specific type of risk (eg interest rates) above a pre-determined level (eg above 5%) using an interest rate cap. In this situation, the entity hedges *some* parts of a specific type of risk (ie interest rate exposure above 5%). An entity might also combine two one-sided hedges of a risk, eg cash flow variability attributable to interest rate exposure above and below a pre-determined level using an interest rate collar.

*Implications of components of (the overall) risk*

15. The designation of components of risks as hedged items gives rise to particular challenges because it involves:

(a) identifying the risk component within the item; issues arise when the risk component is not contractually specified and is inferred or imputed eg:

(i) a specific type of risk in a non-financial item – crude oil component of jet fuel; or

(ii) the exposure in a partial term hedge – the two year interest exposure component in a five year instrument.

(b) isolating and measuring cash flow variability or fair value changes attributable to that risk component.

16. The isolation and measurement of cash flow variability or fair value changes attributable to the specific risk component is important as it relates to the determination of effectiveness and ineffectiveness of the hedging relationship.

***Main issues***

17. As noted there are numerous permutations to components. For example, an entity might hedge more than one specific risk within an instrument, ie two or more components. An entity might hedge both the foreign currency risk exposure and the oil price risk exposure in a forecast purchase of oil. An entity might further combine this with a hedge of a component of a nominal amount, eg the first 100 barrels of the oil purchases in June 201X.

18. Based on the staff's outreach, risk-specific components are most common in practice. Hence, although this series of papers aims to comprehensively address all types of components illustrated in Appendix B, the papers will mainly focus on components of specific types of risks.

19. This series of papers will address the following issues:

(a) Components of specific types of risks (Agenda paper 8C).

(b) Components of nominal amounts (later meeting).

(c) Time components – partial-term hedges (later meeting).

# Appendix A

***IAS 39 requirements (included for reference only)***

A1. Paragraph 81 of IAS 39 *Financial Instruments: Recognition and Measurement* sets out the current requirements relating to the designation of portions as hedged items.

> If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured.

A2. Paragraph AG99E provides further guidance on what a portion is by stating that:

> Paragraph 81 permits an entity to designate something other than the entire fair value change or cash flow variability of a financial instrument. For example:
>
> (a) all of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to some (but not all) risks; or
>
> (b) some (but not all) of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to all or only some risks (ie a 'portion' of the cash flows of the financial instrument may be designated for changes attributable for changes to all or only some risks).

A3. IAS 39 currently distinguishes between portions relating to financial instruments and portions relating to non-financial items. The requirements for non-financial items are set out in paragraph 82:

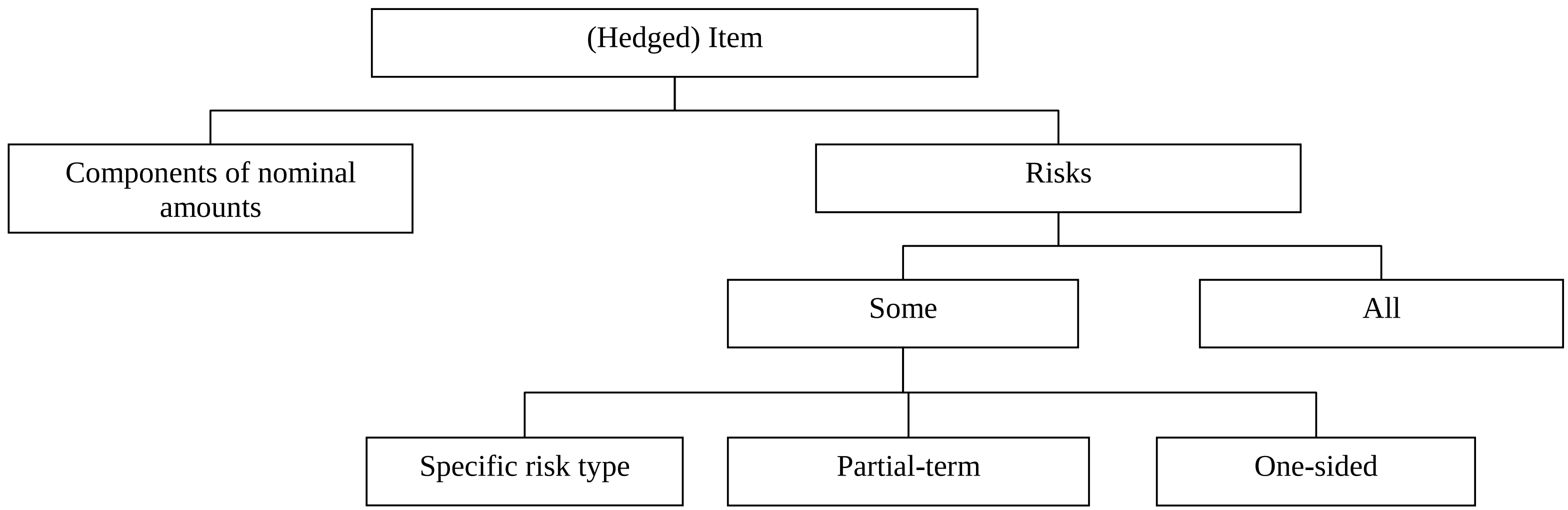
> If the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item (a) for foreign currency risks, or (b) in its entirety for all risks, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks.

A4. Paragraph AG100 provides further guidance by stating that:

> Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item

that is comparable to the effect of, say, a change in market interest rates on the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign exchange risk.[…]

# Appendix B


(Hedged) Item
Components of nominal amounts
Risks
Some
All
Specific risk type
Partial-term
One-sided