Project **Financial Instruments (Replacement of IAS 39) – Hedge Accounting**

Topic **Eligible hedged items: derivatives as hedged items**

Introduction

Background

1. This paper is one in a series of papers that address aspects of eligibility for designation as a hedging relationship.

2. For the purpose of this paper the term 'eligibility' is used in a broader sense of items that *could* be part of a hedging relationship. It should not be construed to imply that hedge accounting remains elective (ie references to 'eligibility' or 'eligible' as well as 'designate' or 'designation' in this paper are without prejudice). Whether hedge accounting will be optional or mandatory will be discussed at a later stage of this project.

Purpose of the paper

3. The purpose of this paper is to discuss whether derivatives (including 'synthetic' positions involving derivatives) should be eligible hedged items. Appendix A provides a comparison with existing IFRS hedge accounting requirements.

The issue

4. Hedging relationships consist of hedging instruments and hedged items. Whether an item can be designated as either a hedging instrument or a hedged

item as part of a synthetic position is relevant for two aspects of hedge accounting:

(a) how hedging relationships can be designated; and

(b) hedge effectiveness.

5. This paper addresses the first aspect and only in the narrow context of whether derivatives can be a hedged item. Other questions about what might be eligible as hedged items are not addressed in this paper. Hedge effectiveness is also not addressed in this paper.

6. The subject of this paper is a long-standing issue raised, in particular, by many non-financial entities that are (i) economically required to enter into transactions that result in commodity or interest rate risk and foreign exchange risk, and (ii) seek to manage those risks independently of each other. The IASB has been asked to address this issue on many occasions. For example, it was a common issue raised in response to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments*. It has also been the subject of past discussions by the IASB's Financial Instruments Working Group (FIWG).

7. Prima facie it may appear as if a derivative that is in the scope of the financial instrument requirements would not have to be eligible for designation as a hedged item. The rationale is that the hedged item would be measured at fair value through profit or loss anyway so hedge accounting would not have an effect.

8. However, this view is inconsistent with some common risk management strategies that build up cover for different exposures of an item or transaction at different points in time. These strategies are best explained using examples.

Examples

9. One example are exposures related to forecast coffee purchases, which include:

(a) **commodity price risk**: the risk of changes in the coffee price, which is commonly determined on a US dollar (USD) basis; and

(b) **foreign exchange (FX) risk**: the risk of exchange rate changes against the USD for any purchaser with a functional currency other than USD.

10. While these two exposures can be managed together at the same time and for the entire term many entities use different risk management strategies for the commodity price risk and the FX risk.

11. This has many reasons. For example, the FX risk may be managed on the basis of the entity's overall FX position taking into account FX cash flows from different sources and for different purposes and may be managed for different time horizons than commodity price risk. It is common to use a 'layering approach' whereby the FX risk is covered progressively over time (eg 20% of anticipated exposure two years in advance, increasing to 60% one year in advance and 80% six months in advance).

12. For example, an entity may hedge a given quantity of anticipated coffee purchases in two years' time using a two-year future contract for coffee. The anticipated coffee purchases and the future contract for coffee in combination are viewed as a two year fixed amount USD FX risk exposure for risk management purposes (ie like any fixed amount USD cash outflow in two years' time).

13. Similarly to the example of the coffee purchase this issue also arises on other purchases or sales of commodities such as metals, grain or crude oil.

14. Another common example are exposures related to fixed rate debt denominated in a foreign currency, which include:

(a) **FX risk**: the risk of exchange rate changes between the borrower's functional currency and the currency in which the debt is denominated (contractual currency); and

(b) **interest rate risk**: the risk of changes in the fair value of the debt in response to changes in the interest rate (in the contractual currency).

15. Entities raise debt denominated in different currencies for many reasons, including pricing efficiencies that can be achieved by raising debt for example in the USD or Euro (EUR) public markets as compared to relatively illiquid domestic debt markets.

16. Again, these two exposures can be managed together at the same time and for the entire term, eg using a cross currency interest rate swap (CCIRS) for the entire term that swaps the fixed rate FX debt into variable rate 'domestic debt'[1].

17. However, it is common for entities to use different risk management strategies for the FX risk and the interest rate risk. One of the main reasons is again that the two exposures are managed for different time horizons.

18. For example, for a 10-year loan an entity may hedge the FX risk for the entire term of the debt instrument but require fixed rate exposure in its functional currency for the short to medium term (say two years), with floating rate exposure in its functional currency for the remaining term to maturity. At the end of each of the two-year intervals the entity fixes the next two years (if the interest level is such that the entity wants to fix interest rates).

19. This means that the 10-year fixed-to-floating CCIRS that swaps the fixed rate FX debt into variable rate domestic debt is then overlaid with a two-year domestic interest rate swap (IRS) that – on the basis of the functional currency – swaps variable rate debt into fixed rate debt. In effect, the fixed rate FX debt and the 10-year fixed-to-floating CCIRS in combination are viewed as domestic 10-year variable rate debt for risk management purposes.

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[1] For the purpose of this paper 'domestic debt' is an obligation in the functional currency of the borrower.

20. These examples illustrate that from a risk management perspective:

    (a) different strategies may be used for different exposures; and

    (b) a risk management strategy might be based on and take into account the effect of another strategy, thereby viewing the combination of the original exposure and an already existing hedge (ie the synthetic position involving a derivative) as the managed exposure.

Implications for hedge accounting

21. To reflect common risk management practice, for a hedging strategy based on another hedge the combination of the original exposure and the other hedge (ie the synthetic position involving a derivative) should be eligible for designation as the hedged item. That is to say, derivatives should be eligible for inclusion in the designation as the *hedged item* in a hedging relationship because they are part of the ultimate exposure that the entity risk manages.

22. The consequence of including derivatives in the synthetic position that is eligible as a hedged item is illustrated using the two examples presented earlier in this paper[2].

Examples

23. In the example of forecast coffee purchases assume the following:

    (a) the functional currency of the entity is EUR;

    (b) the volume of the forecast coffee purchases is 112,500 lbs in two years' time;

    (c) the entity has hedged the coffee price of the forecast purchase volume with two-year coffee futures at 1.25 USD/lb; and

[2] See paragraphs 9-10 and 14-15.

(d) the entity hedges the FX risk using FX forward contracts and a layering strategy of 20% of anticipated exposure two years in advance, increasing to 60% one year in advance and 80% six months in advance.

24. The entity could designate hedging relationships for the FX risk as follows:

    (a) first layer (two years before purchase):

        (i) hedging instrument: two-year FX forward contract for USD 28,125 (exchange EUR for USD);

        (ii) hedged item: the first USD 28,125 cash flow resulting from the forecast coffee purchases including the effect of the coffee futures that fix the coffee price (ie 112,500 lbs × 1.25 USD/lb × 20%).

    (b) second layer (one year before purchase):

        (i) hedging instrument: one-year FX forward contract for USD 56,250 (exchange EUR for USD);

        (ii) hedged item: the USD 56,250 cash flow resulting from the forecast coffee purchases after the first layer of USD 28,125 including the effect of the coffee futures that fix the coffee price (ie 112,500 lbs × 1.25 USD/lb × 40%).

    (c) third layer (six months before purchase):

        (i) hedging instrument: six-month FX forward contract for USD 28,125 (exchange EUR for USD);

        (ii) hedged item: the USD 28,125 cash flow resulting from the forecast coffee purchases after the first and second layer of USD 84,375 (combined) including the effect of the coffee futures that fix the coffee price (ie 112,500 lbs × 1.25 USD/lb × 20%).

25. In the example of fixed rate debt denominated in a foreign currency assume the following:

    (a) the functional currency of the entity is Australian Dollar (AUD);

    (b) the entity issues USD 500m of 10-year fixed rate debt at 4.2%;

(c) the entity hedges the FX risk using a 10-year fixed USD to floating AUD CCIRS to swap the USD 500m into AUD 700m at 3m-BBSW[3] plus 70 basis points; and

(d) the entity hedges the two-year cash flow interest rate risk regarding its variable interest exposure (in AUD) using a two-year IRS (receive 3m-BBSW and pay 5.5% on AUD 700m nominal amount).

26. The entity could designate a hedging relationship for the cash flow interest rate risk (in AUD) as follows:

(a) hedging instrument: two-year IRS;

(b) hedged item: the benchmark (BBSW) component of the interest cash flows on 700m AUD variable rate exposure (ie the interest cash flows on the debt including the effect of the CCIRS) for the first two years after the issue date.

27. Similar designations could be used on subsequent dates when any previous two-year IRS expires.

Conclusion

28. Permitting derivatives to be included in the synthetic positions designated as hedged items is required if hedge accounting is going to reflect common risk management techniques whereby different risk management strategies are used for different risks. Otherwise, financial reporting would not provide correct information about the purpose and effect of derivatives used as hedging instruments in managing the entity's exposures in the context of the entity's risk management strategy. In other words, financial reporting would not correctly reflect how an entity's risk management activities affect its performance and financial position.

[3] Bank Bill Swap Rate (Australian reference interest rate similar to what LIBOR is for other currencies).

Staff recommendation and question to the board

29. The staff recommends that for hedge accounting purposes derivatives generally are eligible hedged items. That is to say, the fact that a synthetic position is created by including an instrument that has the characteristics of a derivative should not, in itself, preclude designation of that synthetic position as a hedged item. Of course, as this project progresses, the board may decide on other limitations on hedging relationships, which may affect whether a synthetic position including a derivative – or any other item – is eligible for designation.[4]

30. The staff's rationale is that the recommendation would facilitate aligning financial reporting and common risk management practice (see paragraph 28)[5] and, hence, avoid artificially overstated hedge ineffectiveness[6].

Question – eligibility of derivatives as a hedged item
Does the board agree with the staff recommendation that derivatives generally are eligible hedged items? If the board disagrees with the staff recommendation, what are the eligibility criteria the board proposes for derivatives as hedged items and why would that improve financial reporting?

[4] For example, if at a later stage of this project the consistency of the hedging relationship with risk management policies were established as a qualifying criterion for a hedging relationships, this would preclude derivatives that are not used for hedging in accordance with the entity's risk management policies from being eligible as a hedged item (notwithstanding that the type of instrument – ie being a synthetic position including a derivative – would generally not preclude designation as a hedged item).
[5] See also paragraph A7 in Appendix A.
[6] See also paragraph A6 in Appendix A.

Appendix A

Comparison with existing IASB hedge accounting requirements

A1. The Implementation Guidance to IAS 39 *Financial instruments: Recognition and Measurement* says that derivatives can only be designated as hedging instruments but not as hedged items (neither individually nor as part of a group of hedged items).[7] As the sole exception, IAS 39.AG94 allows a purchased option to be designated as a hedged item (if hedged by a written option).

A2. In practice this has resulted in derivatives being considered to generally not qualify as hedged items (with the above mentioned exception for some purchased options) and, similarly, synthetic positions including derivatives being considered to not qualify as hedged items.

A3. The rationale for not permitting derivatives (or synthetic positions including derivatives) to be designated as hedged items appears to be that given in the Implementation Guidance to IAS 39:

> 'Derivative instruments are always deemed held for trading and measured at fair value with gains and losses recognised in profit or loss unless they are designated and effective hedging instruments (IAS 39.9).'

A4. This rationale is difficult to justify conceptually in the light of the above mentioned exception for some purchased options that qualify as hedged items irrespective of whether the option is a stand-alone or an embedded derivative. If a stand-alone purchased option can be a hedged item then prohibiting derivatives that are part of a synthetic exposure to be part of a hedged item is arbitrary.

[7] IAS 39 Implementation Guidance, IG F.2.1.

A5. More importantly, this rationale ignores that derivatives can have a dual role as (i) the hedging instrument that hedges one item in a first hedging relationship and at the same time as (ii) part of an exposure in combination with that hedged item in another hedging relationship.

A6. In such a scenario, prohibiting the derivative (or a synthetic position including a derivative) to be designated as the hedged item is tantamount to disqualifying the first hedging relationship, which results in overstating hedge ineffectiveness. The overstatement of hedge ineffectiveness results from the necessity to de-designate the derivative that is part of the synthetic exposure and then re-designate it in combination with another derivative as the hedging instrument. This means the first derivative (ie the coffee future and the CCIRS in the above examples) is already in- or out-of-the-money at the time of re-designation, which results in hedge ineffectiveness. This hedge ineffectiveness is artificial because the entity actually hedged the coffee price risk and the cross currency interest rate risk from inception of the first hedging relationship instead of the time of re-designation.

A7. The overstatement of hedge ineffectiveness also reflects the mismatch between hedge accounting and risk management in this scenario. In combination with the hedge effectiveness testing many entities struggle to achieve hedge accounting at all in such scenarios. This creates the danger of a complete disconnect between financial reporting and risk management.