Project	**Financial Instruments (Replacement of IAS 39) – Hedge Accounting**
Topic	**Eligible hedged items: Groups and net positions – cover paper**

Introduction

Background and purpose of this paper

1. At the April 2010 Board meeting the Staff presented its overall approach to the hedge accounting phase of the project to replace *IAS 39 Financial Instruments: Recognition and Measurement.*

2. As part of that overall approach the Staff indicated that it would consider what, if any, eligibility criteria should apply to:

   (a) groups of hedged items that constitute a gross position ('groups'); and

   (b) groups of hedged items that constitute a net position ('net positions').

3. Groups and net positions are considered together because a net position is a group of at least two partially offsetting gross positions.

4. **This paper explains:**

   (a) why the Board needs to consider this issue;

   (b) current accounting requirements;

   (c) range of characteristics of groups of hedged items; and

   (d) some high-level issues that arise, and our approach to tackling this topic.

5. This paper does not ask the Board for any decisions.

Why consider eligibility of groups of hedged items and net positions?

6. There are two primary reasons:

   (a) hedging groups of items and net positions is a common risk management strategy; and

   (b) it is a necessary step towards assessing the hedge accounting criteria that apply in the 'macro' or 'portfolio' hedging model.

A common risk management strategy

7. Constituents have repeatedly told us (both during our outreach activities and from past comment letters responding to discussion papers and exposure drafts on hedge accounting) that restricting the ability to hedge account for groups of items, including net positions, results in a hedge accounting model that is inconsistent with the way in which entities commercially hedge.

8. Entities hedge their risk exposures in many different ways. Examples of these different hedging strategies are given in Appendix B. These can broadly be categorised as hedges of:

   (a) individual items; or

   (b) groups of similar items that form a **gross** position; or

   (c) groups of partially offsetting items that result in a **net** position.

9. An individual hedging transaction involves an entity entering into one or more hedging instruments with matching terms to the hedged item to derive a desired synthetic hedged position. For example an entity that issues a fixed rate bond may enter into a receive-fixed, pay-float, interest rate swap where the fixed leg perfectly matches the fixed interest payments on the bond. This achieves the desired synthetic hedged position of floating rate debt.

10. The group hedging approach involves identifying the risk from particular groups of items (on a gross or net basis), and then hedging some or all of that risk with one or more hedging instruments.

11. This strategy does not identify a specific hedged item but instead views the risk at a higher aggregated level. Reasons that such an approach is taken include (but are not limited to):

    (a) The expediency (cost, practicality etc.) of entering into one derivative as a hedging instrument rather than multiple hedging derivatives.

    (b) The minimisation of counterparty credit risk exposure because of offsetting risk positions (especially important for entities that have regulatory capital requirements).

    (c) The reduction of gross assets/liabilities in the statement of financial position because offset accounting may not be achieved if multiple derivatives (with offsetting risk exposures) are entered into.

    (d) The exposures are managed on a group basis for risk management purposes and are not analysed at the individual item level.

    (e) Items in the group have some offsetting risk positions which provide a natural hedge of some of the risks in the group and therefore those offsetting risks do not need to be separately hedged.

    (f) Hedging derivatives that hedge different risks together can be more readily available than individual derivatives each hedging a different risk.

12. Given the prevalence of such hedging strategies the Board should consider whether hedge accounting should be available in any or some situations (‘eligibility criteria’). And, in situations that hedge accounting is not available, the accounting reasons why.

General hedge accounting model vs. ‘macro’ or ‘portfolio’ hedging model

13. This issue needs to be considered in the context of the general hedge accounting model applicable to all types of hedges and all types of possible eligible hedged risks (eg covers both non-financial risks and financial risks).

14. This is also a necessary stepping stone to assessing possible hedge accounting criteria that apply to any ‘macro’ or ‘portfolio’ hedging model.

15. The extent to which the Board decides that hedge accounting can accommodate groups of hedged items and net positions in the general model may affect any approach taken in the context of a portfolio hedge accounting model.

Current accounting requirements

16. Today there are restrictions that apply for hedges of groups and net positions. These are stated more fully in Appendix A.

17. Hedged items that together constitute a net position do not qualify for hedge accounting.

18. Other groups are eligible if the individual items within that group have similar risk characteristics (IAS 39.78) and share the risk exposure that is designated as being hedged (IAS 39.83). Furthermore the change in fair value attributable to the hedged risk for each individual item in the group must be approximately proportional to the overall change in fair value of the group for the hedged risk (IAS 39.83).

19. The general effect of these restrictions is that a hedged item will generally only qualify as part of a group of hedged items if it would qualify for hedge accounting for the same hedged risk on an individual basis.

20. Today’s requirements can be viewed as a practical alternative to individually hedging single items in single hedge relationships.

21. That is, today’s approach in the general hedge accounting model essentially takes an individual hedged item approach (or, in the words of one Board member, a ‘onesy approach’).

Range of characteristics of groups of hedged items

22. The characteristics of groups of hedged items can vary significantly. This makes any analysis challenging as some but not all characteristics may be important for accounting. The following list is a sample of different characteristics that a group of hedged items may exhibit (individually and/or collectively):

    (a) Gross positions vs. net positions

    (b) Financial items vs. non-financial items

    (c) Items in the group affect profit or loss in the same reporting period vs. different reporting periods

    (d) Group hedged for common risk vs. residual group risk

    (e) Group contains existing items vs. forecast transactions[1]

    (f) Group contains hedged items of same nature vs. combination of different nature (eg forecast transactions mixed with firm commitments)

    (g) Group hedged for a single risk vs. multiple risks

    (h) Group contains on-balance sheet items vs. off-balance sheet items

    (i) Closed groups vs. dynamic ('open') groups

23. The examples in Appendix B exhibit some of these different characteristics.

Some key issues that arise from hedging groups of hedged items*, and our approach to tackling this topic*

Some key issues

24. The Staff has identified three key issues that arise from hedge accounting for groups of items:

[1] For hedge accounting purposes under IAS 39 the group of hedged items may be designated in a fair value hedge or a cash flow hedge (depending on the characteristics of the hedged items).

(a) The '*where*' issue: The **profit or loss geography** of gains and losses (from both hedged item and hedging instrument) is an issue where the hedged items in the group affect profit or loss in different line items.[2]

(b) The '*when*' issue: The **timing of recognition in profit or loss** of gains and losses (from both hedged item and hedging instrument) is an issue where the hedged items in the group affect profit or loss in different reporting periods.[3]

(c) The '*what*' issue: **Identifying the hedged item** is an issue where a group of hedged items is hedged for a specified amount but without identifying specific hedged items.[4]

25. The '*where'* and '*when'* issue will be isolated and addressed in two separate Staff papers presented at this Board session (see paragraph 32, paper 9B considers the '*where'* issue and paper 9C considers the '*when'* issue). A separate paper addressing the '*what*' issue will be presented to the Board at a later date.

26. Other related items will be addressed as part of the other components of the hedge accounting model. Such items include:

(a) *Eligibility criteria* that apply to all hedged items (either individually hedged or hedged as part of a group).

(b) Assessing and measuring *hedge effectiveness* of designated hedges.

(c) *Mechanics* of applying hedge accounting for designated hedges.

[2] Note that this issue arises in Example 5 (paragraph B6 of Appendix B).
[3] Note that this issue arises in Example 6 (paragraph B7 of Appendix B) if the hedging entity is assumed to have a year end of 31 December 2009.
[4] Note that this issue arises in Example 5 (paragraph B6 of Appendix B) if the hedged item is designated as a net position of $20 (ie non-specific).

Papers to be presented to the Board

Step 1		Step 2		Step 3
Agenda Paper 9A Groups of: **Gross** positions To analyse: Basic eligibility criteria for hedging basic groups	→	**Agenda Paper 9B** Groups of: **Net** positions To analyse: The '*where*' issue that arises from hedging net positions	→	**Agenda Paper 9C** Groups of: **Net** positions To analyse: The '*where*' **and** '*when*' issue that arises from hedging net positions.

27. The Staff proposes to present a number of papers to the Board to analyse various issues that arise from hedging groups and net positions. These papers will consider various risk management techniques and ask the Board whether the hedge accounting model should permit hedge accounting for such types of group hedges.

28. Given the large population of different types of groups (see paragraph 22) the Staff has selected three specific subsets of groups with particular characteristics for the Board to consider.

29. The Staff believes these subsets are an appropriate starting point for considering eligibility criteria for the population of groups more generally as they will help to gauge the Board's view on a number of issues that arise.

30. The scope of future Staff papers on the topic will be widened or narrowed depending on the Board's view on these groups and decisions taken.

31. For example if the Board does not believe any of the groups noted in paragraph 32 should qualify for hedge accounting then it may not be necessary to separately consider certain other types of groups. Instead it may indicate that the Staff should further consider hedge accounting disclosures to address risk management issues that the hedge accounting model cannot address because of the objective, and constraints, of financial reporting.

32. The groups considered in the separate agenda papers are:

(a) **Agenda paper 9A:** Closed groups of hedged items that are *gross* positions, of the same nature, with different risk characteristics, that affect P/L in the *same* reporting period. Note that this paper does not give rise to any of the issues in paragraph 24 because all items affect profit or loss in the same line item and same reporting period and are hedged in their entirety.

(b) **Agenda paper 9B:** Closed groups of *net positions* of existing, non-financial hedged items, with different risk characteristics, that affect P/L in the *same* reporting period that are fair value hedges. Note that this paper considers the '*where*' issue identified in paragraph 24 because the hedged items affect different income statement line items.

(c) **Agenda paper 9C**: Closed groups of *net positions* of existing, non-financial hedged items, with different risk characteristics, that affect P/L in *different* reporting periods that are fair value hedges. Note that this paper considers the '*where'* and '*when'* issue identified in paragraph 24 as the hedged items affect profit or loss in different reporting periods.

33. For the avoidance of doubt, Appendix C sets out a summary of the different characteristics from paragraph 22 covered by these subsets of groups.

Appendix A

A1. The following two paragraphs from IAS 39 impose restrictions on the types of groups of items (excluding net positions) that qualify for hedge accounting:

> A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.[IAS 39.78].
>
> Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.[IAS 39.83]

A2. The following example is taken from the implementation guidance of IAS 39:

> **F.2.20 Hedge accounting: stock index**
>
> **An entity may acquire a portfolio of shares to replicate a stock index and a put option on the index to protect itself from fair value losses. Does IAS 39 permit designating the put option on the index as a hedging instrument in a hedge of the portfolio of shares?**
>
> No. If similar financial instruments are aggregated and hedged as a group, IAS 39.83 states that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in the fair value attributable to the hedged risk of the group. In the scenario above, the change in the fair value attributable to the hedged risk for each individual item in the group (individual share prices) is not expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.

Appendix B

B1. Entities hedge their risk exposures in many different ways depending on a variety of factors. These risk management strategies vary in complexity. Below are some examples of different approaches to managing risks in order of increasing complexity. Note that these are examples of economic hedges not necessarily hedges that qualify for hedge accounting.

B2. **Example 1 – no separate hedging instrument.** Some entities reduce risk exposures by negotiating contracts with in-built hedges (ie no separate hedging instrument is needed). For example fixing, with the supplier, the price for goods and services contracted from abroad in the entity's own functional currency thus hedging the foreign exchange risk.

B3. **Example 2 – a hedge of a single hedged item**. Some entities hedge risks by transacting specific hedging instruments to offset the risk exposure from each individual hedged item. The objective here is to synthetically achieve the position in Example 1. For example a company with contracts to purchase goods in a foreign currency may trade individual forward FX contracts with matching terms (eg notional and settlement date of the forward match those of the purchase contracts) to fix the cost of each individual order of goods in its functional currency.

B4. **Example 3 – a hedge of a group of items with similar risk characteristics (excluding net positions)**. Some entities may hedge items of the same nature (eg highly probable forecast cash flows, firm commitments, etc) with similar risk exposures (eg foreign currency risk, market price risk, interest rate risk, etc) collectively in groups. For example instead of hedging each individual purchase of goods denominated in the same foreign currency with a separate FX forward, an entity might hedge a number of purchase contracts settling in the same month together with one FX forward. To mitigate intra-month FX exposure arising from a mismatch in timing of settlement on purchase contracts and forward FX contracts a $ bank account is used to deposit $ cash received on the forward contract and fund $ cash required for purchases.

B5. **Example 4 – a hedge of a group of items with different risk characteristics (excluding net positions).** Some entities may hedge items of the same nature (eg highly probable forecast cash flows, firm commitments, etc) with different risk exposures (eg combinations of different risks such as foreign currency risk, market price risk, interest rate risk, etc) collectively in groups. For example an entity hedges against the price decline of a portfolio of equities it holds that comprise the FTSE 100 with a put option linked to the index. The items in this case are similar (eg equities) however the individual risk exposures are different (eg the equity price risk of each individual stock is different).

B6. **Example 5 – a hedge of a group of items that is a net position within a narrow time band (ie hedged items settle in narrow time band).** Entities that have naturally offsetting risk positions within a narrow time band (eg a month) may hedge only the net position within that time band. For example a Euro entity may hedge the net position of forecast purchases of $100 and forecast sales of $120 in a given month with a single FX forward to sell the net cash inflow of $20. To mitigate intra-month FX exposure arising from mismatches in timing of cash flows a $ bank account is used for $ cash settlements.

B7. **Example 6 – a hedge of a group of items that is a net position across a broad time period (ie hedged items settle at different times).** Some more sophisticated risk management strategies may consider naturally offsetting risk positions within and across time bands and then hedge only the net position across the multiple time bands. For example a Euro entity that in July 2009 expects to buy goods for $100 in December 2009 to sell them four months later in April 2010 for $120 may only hedge the net exposure of $20 (with an FX forward maturing in April 2010). The interim four month exposure on $100 of the sale (from December 2009 to April 2010) may either be (1) naturally hedged with a $100 borrowing taken out to purchase the goods which is repaid from the proceeds of the sale arising in April 2010; (2) hedged with an additional FX forward for $100 traded in December 2009, or (3) left unhedged.

B8. In practice the group hedging approaches discussed above exist for both cash flow hedges and fair value hedges; for hedges of non-financial risks as well as financial risks; and for closed portfolios as well as dynamic portfolios (where the hedged item changes or is replaced over time)

Appendix C

1. The subsets of groups identified in paragraph 32 include groups with the following characteristics:

Legend: Characteristics included
Characteristics excluded

Paragraph 32(a) Agenda paper 9A

Characteristic			
Type of hedge:	Fair value hedge	vs.	Cash flow hedge
Overall position of the group:	Gross position	vs.	Net positions
Type of hedged item:	Financial items	vs.	Non-financial items
The reporting period the hedged items affect profit or loss:	Same reporting period	vs.	Different reporting periods
The commonality of the risk being hedged amongst the hedged items:	Common risk	vs.	Residual risk
The nature of the hedged item:	Existing/contractual items	vs.	Forecast transactions
The combination of hedged items of different nature (eg forecast transaction, firm commitment, etc):	All same	vs.	Mixture
The number of risks the group is hedged for:	Single risk	vs.	Multiple risks
Recognition of hedged item:	On-balance sheet	vs.	Off-balance sheet
How the hedged items might change:	Closed group	vs.	Dynamic open group

Paragraph 32(b) Agenda paper 9B

Characteristic			
Type of hedge:	Fair value hedge	vs.	Cash flow hedge
Overall position of the group:	Gross position	vs.	Net positions
Type of hedged item:	Financial items	vs.	Non-financial items
The reporting period the hedged items affect profit or loss:	Same reporting period	vs.	Different reporting periods
The commonality of the risk being hedged amongst the hedged items:	Common risk	vs.	Residual risk
The nature of the hedged item:	Existing/contractual items	vs.	Forecast transactions
The combination of hedged items of different nature (eg forecast transaction, firm commitment, etc):	All same	vs.	Mixture
The number of risks the group is hedged for:	Single risk	vs.	Multiple risks
Recognition of hedged item:	On-balance sheet	vs.	Off-balance sheet
How the hedged items might change:	Closed group	vs.	Dynamic open group

Paragraph 32(c) Agenda paper 9C

Characteristic			
Type of hedge:	Fair value hedge	vs.	Cash flow hedge
Overall position of the group:	Gross position	vs.	Net positions
Type of hedged item:	Financial items	vs.	Non-financial items
The reporting period the hedged items affect profit or loss:	Same reporting period	vs.	Different reporting periods
The commonality of the risk being hedged amongst the hedged items:	Common risk	vs.	Residual risk
The nature of the hedged item:	Existing/contractual items	vs.	Forecast transactions
The combination of hedged items of different nature (eg forecast transaction, firm commitment, etc):	All same	vs.	Mixture
The number of risks the group is hedged for:	Single risk	vs.	Multiple risks
Recognition of hedged item:	On-balance sheet	vs.	Off-balance sheet
How the hedged items might change:	Closed group	vs.	Dynamic open group