
Project	Financial Instruments (Replacement of IAS 39) – Hedge Accounting
Topic	Eligibility of derivatives embedded in financial assets as hedging instruments

Introduction

Background

1. This paper is one in a series of papers that address aspects of eligibility for designation as part of a hedging relationship.
2. For the purpose of this paper the terms ‘eligible’ and ‘eligibility’ are used in a broad sense to denote items that *could* be part of a hedging relationship. This paper does not address, or prejudge, the question of whether hedge accounting will be optional or mandatory. This will be address at a later stage of this project.

Purpose of the paper

3. This paper discusses whether derivatives embedded in financial assets should be eligible hedging instruments in the new hedge accounting model.
4. This paper is all about hedge accounting. It considers possible ways to facilitate hedge accounting in particular situations. This paper does not suggest changing the classification approach in IFRS 9 *Financial Instruments*, which was finalised after the Board deliberated the substantial input from constituents received prior to the issuance of IFRS 9.
5. This paper is structured as follows:
 - (a) overview of the issue;

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of 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 IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

IASB Staff paper

- (b) staff analysis; and
- (c) staff recommendation and question to the Board.

The issue

6. Should derivative features embedded in hybrid financial assets be eligible hedging instruments in the context of hedge accounting?
7. As part of the development of IFRS 9¹, the Board decided to revise the requirement in IAS 39 *Financial Instruments: Recognition and Measurement* on accounting for derivatives embedded in financial assets. This followed requests by many constituents in response to the IASB discussion paper *Reducing Complexity in Reporting Financial Instruments*, comments received from many as a result of the exposure draft issued in July 2009 that preceded the issue of IFRS 9, and the feedback from many (most notably users of financial statements) during the significant outreach efforts. Many constituents argued that the requirements for embedded derivatives in IAS 39 are complex, too rules-based and internally inconsistent.
8. As a result of this, the Board considered two options when developing IFRS 9: maintaining the requirements in IAS 39, or using the same classification approach for all financial assets. The Board decided not to pursue the current model in IAS 39, because it is based on the ‘closely related’ assessment. This assessment is based on a list of examples, which makes the assessment difficult to apply.
9. As a result of this, the Board proposed in the exposure draft preceding IFRS 9 to measure many hybrid (‘combined’) financial assets at fair value, with changes in fair value being recognised in the income statement. This was finalised in IFRS 9 which cited the following arguments²:

¹ Refer to BC53 to BC60 of the Basis for Conclusions to IFRS 9.

² Refer to BC53 to BC60 of the Basis for Conclusions of IFRS 9.

IASB Staff paper

- (a) The elimination of the embedded derivatives guidance for financial assets containing embedded derivative features will reduce complexity, because it eliminates another classification approach.
 - (b) The underlying rationale for separating embedded derivatives in IAS 39 is not to reflect risk management activities, but to prevent entities from circumventing the requirements for recognition and measurement of derivatives. The Board sees this as an exception to the unit of account with the aim of preventing abuse. Elimination of an anti-abuse provision will reduce complexity.
 - (c) The issue of the unit of account for the components is, in the Board's view, a much broader issue that would require a separate project. In addition, derivative features often do not have contractually specified cash flows that are independent of the other cash flows in the contract and that solely represent payments of interest and principal. So they would not be eligible for amortised cost. As a result, applying the same classification approach to the hybrid contract as to all other contracts would depict more faithfully the amount, timing and uncertainty of future cash flows of the contract.
10. This decision has a knock-on effect on hedge accounting. This is because derivative-like features embedded in the financial host contract (financial asset) are no longer eligible as a hedging instrument.

IASB Staff paper

Staff analysis

The issue of managing components of a hybrid contract separately

11. For risk management purposes, separate management of components of a contract happens. This is because an entity may manage one component consisting of derivative-like features (for example the derivative-like features of a structured note) separately in contemplation of a risk exposure they want to mitigate. However, it is important to note that such risk management activities do not necessarily (and in fact often are not) based upon the same ‘closely related’ criteria that IAS 39 used for bifurcating derivatives from hybrid contracts). Also note that designation of a bifurcated embedded derivative as a hedging instrument in IAS 39 is very uncommon in practice.
12. Applying the IFRS 9 requirements means that in such circumstances the derivative part (as set out in IAS 39 using the ‘closely related’ criteria) of the hybrid financial asset is not eligible as for designation as a hedging instrument unless the Board changes the eligibility criteria for *hedging instruments*.
13. The staff believe that there are at least three possible alternatives for the Board to consider:

Alternative 1—Make bifurcation of embedded derivatives a choice but solely in the context of hedge accounting (ie conditional on the use of the separated embedded derivative as a hedging instrument).

Alternative 2—Allow designation of risk components of the hybrid financial asset as the *hedging instrument*.

Alternative 3—Do not accommodate hedge accounting when the hedging instrument would be a risk component of a hybrid financial asset.
14. The staff provide an analysis below for each of the alternatives:

Alternative 1
15. One of the possible solutions is to bring back the bifurcation rules in IAS 39, but only in the context of hedge accounting.

IASB Staff paper

16. The staff believe that this option is not appropriate because it raises several issues and inconsistencies.

Misalignment of ‘closely related’ notion and risk management

17. When issuing IFRS 9 the Board acknowledged that the criterion ‘closely related’ was arbitrary and difficult to apply and that it had led to significant diversity in practice. Hence, separating embedded derivatives based on the notion of ‘closely related’ is inconsistent with the overall objective of hedge accounting, ie achieving offsetting changes between the fair value of the hedged item attributable to the hedged risk and the fair value of the hedging instrument.
18. In particular, the notion of ‘closely related’ does *not* reflect a risk management view because the potential of an embedded feature to provide protection against a risk exposure does not depend on how the embedded feature relates to its host contract (but rather the nature of the exposure).
19. In fact, the embedded derivative requirements of IAS 39 were not designed with the objective of facilitating hedge accounting but as an anti-abuse provision.³ The eligibility as hedging instruments of separated embedded derivative in IAS 39 is merely a consequence of the accounting treatment mandated because of anti-abuse considerations (ie a ‘by-product’ or side effect).
20. Therefore, the staff considers that if facilitating hedge accounting is the objective then re-introducing bifurcation of embedded derivatives would be the wrong way to achieve that objective.

Conceptual considerations—creating an exception to IFRS 9

21. Allowing bifurcation in the context of hedge accounting would require creating an exception to the general measurement model in IFRS 9. This exception would then require another exception upon discontinuation of hedge accounting, because the two components of the hybrid instrument (derivative and host) would:

³ See paragraph BC37 of the Basis for Conclusions of IAS 39.

IASB Staff paper

- (a) either have to be left separate, which is inconsistent with the IFRS 9 classification and measurement model (as well as creating an opportunity to achieve ‘split accounting’ by designating and then dedesignating the hedge relationship that results in separation of the embedded derivative); or
- (b) have to be ‘merged’ (ie aggregated) when discontinuing the hedging relationship in order to be compliant with the IFRS 9 classification and measurement model. This raises the question of how to account for the difference between the fair value and the amortised cost of any host contract that would have been measured at amortised cost in the meantime.

Practical considerations

- 22. If bifurcation is allowed the IFRS 9 classification criteria (ie the business model test and the evaluation of the contractual cash flow characteristics) would have to be performed for the host contract, to assess whether the host shall be accounted for at fair value or amortised cost. (In developing IFRS 9 the Board considered such an approach). However, this can be a difficult task because the host as such often not have contractual cash flows. Instead, implied substantive terms would have to be used in lieu for classification purposes (similarly to, for example, the determination of implied terms for separating some embedded derivatives under IAS 39⁴).

Conclusion

- 23. Taking the arguments above, the staff believe that bifurcation of hybrid contracts like under IAS 39 is not an appropriate means to facilitate hedge accounting.

⁴ See IAS 39.AG28.

IASB Staff paper

Alternative 2

24. Another approach is to allow risk components of the hybrid financial asset to be designated as eligible *hedging instruments*. This approach differs from alternative 1 in that:
- (a) the accounting for the undesignated part of the hybrid financial asset that is not part of the hedging relationship would not change (compared to classification of the host contract as a separate unit of account under alternative 1);
 - (b) the part that of the hybrid financial asset that would be eligible as a hedging instrument could be aligned with risk management because the notion of ‘closely related’ does not apply.
25. The staff consider that alternative 2 gives rise to at least the following issues:
- (a) Separating structured financial assets into components can be difficult, eg because of the question how to allocate a structuring margin to component parts.
 - (b) If such separation is nonetheless facilitated for non-derivative hybrid financial assets it would raise the much more comprehensive question of how all hedging instruments might be disaggregated, including derivatives. This gives rise to questions such as how to treat elements like the ‘basis’ in a cross currency interest rate swap. Moreover, it would result in similar questions regarding non-financial items (eg non-financial liabilities under IAS 37 with currency or commodity price risk elements), which means the scope of the project would have to be broadened way beyond the starting point of financial instruments accounting.
 - (c) Separation would entail presentation challenges to ensure that any risk components of a non-derivative instrument used as a hedging instrument are transparent on the face of the financial statements.
26. The staff also believe that this is part of the broader issue of whether cash instruments should be eligible hedging instruments in some or all circumstances.

IASB Staff paper

27. The staff therefore believe that pursuing alternative 2 would represent a significant expansion of the scope of the project.

Alternative 3

28. A third alternative is *not* changing the requirements regarding the eligibility as a hedging instrument specifically to accommodate hedge accounting when the hedging instrument is a component of a hybrid financial asset.
29. This view is based on the argument that the possibility for applying hedge accounting under IAS 39 has been created as the consequence of applying an anti-abuse provision but not with the objective to facilitate hedge accounting and that embedded derivative accounting under IAS 39 does not ensure alignment with risk management, which would be coincidental (see paragraphs 17-20) (In fact, it would be surprising if the bifurcation approach in IAS 39 reflected risk management of risk components).
30. For these reasons the staff consider that re-introducing the separation of embedded derivatives for hybrid financial assets would not be an appropriate means to address any hedge accounting concerns because this notion is not targeting hedge accounting considerations.
31. The staff note that bifurcation will continue to apply to financial liabilities and non financial items and therefore derivatives in these instruments will be eligible hedging instruments. However, this is a consequential effect (a ‘by-product’) of an asymmetrical classification model that is based on the paramount considerations of the effect of ‘own credit’.
32. The staff further note that if the Board chooses alternative 3, one way of limiting the impact of derivatives or risk components in hybrid financial assets not being eligible as hedging instruments is to apply the fair value option as an alternative to fair value hedge accounting.
33. Although this alternative does not achieve the same outcome, because hedge accounting would allow the entity to account for the change in fair value of the hedged item attributable to the hedged risk, the fair value option will recognise the full change in fair value of both instruments, and therefore the accounting

IASB Staff paper

mismatch is mitigated. This option is obviously not relevant for cash flow hedges.

Staff recommendation

34. In order to arrive at a recommendation the staff evaluated the pros and cons of the alternatives above.

Alternative 1

35. **Pros:** The status quo of what is eligible as hedging instruments would be retained (ie no entity would be more limited in applying hedge accounting compared to today regarding this aspect of hedge accounting).
36. **Cons:** If bifurcation of hybrid financial assets is allowed only in the context of hedge accounting, the Board would need to reconsider the overall model for bifurcation. The criteria used in IAS 39 are aimed at preventing abuse and therefore will not be suitable for hedge accounting. Because the eligibility of hedge accounting is a ‘by-product’ of bifurcation rather than its objective this would not be a targeted, efficient approach to address hedge accounting concerns. Also, any alignment with risk management based on the bifurcation using approach used in IAS 39 would be purely coincidental

Alternative 2

37. **Pros:** Allowing a risk component of the hybrid financial asset to be a hedging instrument in the context of hedge accounting will allow entities to show more accurately in the financial statements the results of some risk management activities. It is more targeted than re-introducing separation of derivatives embedded in hybrid financial assets.
38. **Cons:** If the Board wants to explore risk components of hybrid financial assets as eligible hedging instruments, it would be a significant expansion of the scope of this project.

IASB Staff paper

Alternative 3

39. **Pros:** It will avoid the increase complexity that would arise from alternatives 1 and 2, because no exceptions to the general classification model in IFRS 9 would be created nor would the scope of what items can be disaggregated and then used for hedge accounting be expanded beyond financial instruments. This also avoids the risks that result from broadening the scope of the project, which inevitably would delay the project.
40. **Cons:** It might result in an entity deciding to enter into a number of separate contracts rather than one hybrid contract to obtain hedge accounting.

Evaluation of alternatives

41. Based on the pros and cons above, the staff dismiss alternative 1 because it is not a targeted solution for concerns related to hedge accounting. Hence, it would not be efficient and add unnecessary complexity.
42. Considering the pros and cons of alternatives 2 and 3 the staff recommend alternative 3.

Question – Embedded Derivatives in hybrid financial assets as eligible hedging instruments

Does the Board agree with the staff recommendation in paragraphs 41 and 42? If not what would the Board recommend and why?