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

Topic **Rebalancing and reassessment of the hedge ratio**

Introduction

Background

1. This paper continues the discussion about discontinuation of hedge accounting. Specifically, This paper addresses the issue of rebalancing and reassessing the hedge ratio of a hedging relationship.

Purpose of the paper

2. This paper discusses the role of rebalancing a hedging relationship.
3. This paper does not address the issue of dedesignation of hedging relationships in the consolidated financial statements of the acquirer following a business combination. This issue is a requirement of IFRS 3 *Business Combinations*, which is not within the scope of this project.
4. This paper also does not address rebalancing changes to a hedging relationship in the context of dynamic hedging because this involves different considerations. Once the Board comes to a tentative decision on dynamic hedging, this issue in that context will be the subject of a separate paper.
5. The staff note that this paper only aims to articulate the notion of rebalancing and its role in the context of the new hedge accounting model. This paper should be read in conjunction with paper 17C for a better understanding of the practical application of rebalancing.
6. This paper has the following structure:

(a) overview of the issue;

(b) staff analysis; and

(c) staff recommendation and question to the Board.

The issue

7. What is the role of rebalancing a hedging relationship and how does it relate to changes to the hedge ratio and discontinuation of hedge accounting?

Staff analysis and alternatives

8. Before addressing the issues of rebalancing and adjustment of a hedge ratio, the staff would like to remind the Board of the tentative decision made at the meeting on 24 August on effectiveness assessment testing. The Board's tentative decision is summarised in Appendix A. Below is the summary of the parts of that decision relating to rebalancing:

(a) The objective of the effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and minimise expected ineffectiveness. Thus, for accounting purposes hedging relationships should not reflect a deliberate mismatch between the weightings of the hedged item and of the hedging instrument within the hedging relationship.

(b) Changes in the method for assessing effectiveness are mandatory if there are unexpected sources of ineffectiveness (ie new sources not initially anticipated), or if, upon a rebalancing in the hedging relationship, the method previously used is no longer capable of capturing the sources of ineffectiveness and is therefore now not capable of demonstrating whether the hedge produces an unbiased result and minimises ineffectiveness.

Why is rebalancing needed?

9. This Board's tentative decision on the new effectiveness assessment test would require entities to rebalance hedging relationships. In the context of the new effectiveness test, such an adjustment to a hedging relationship is considered a *continuation* of an existing hedge. When a hedging relationship is subject to rebalancing, the risk management objective remains the same, but the relationship is adjusted to remain in compliance with the qualifying criteria.

10. With this tentative decision the Board aimed to differentiate:

    (a) scenarios where the design of the hedging relationship is inappropriate and therefore does not meet the qualifying criteria (including the risk management objective), and hence is automatically discontinued with a potential restart; from

    (b) scenarios where the hedging relationship is still appropriate from a risk management perspective but needs to be adjusted to remove the bias created by one or more variables affecting the hedging relationship (commonly termed sources of ineffectiveness).

11. This latter scenario is a *continuation* of an existing hedge that is subject to adjustments without triggering discontinuation of the hedging relationship.

What are the causes of rebalancing?

12. As noted in paragraph 9 above, rebalancing arises when some of the variables affecting the hedging relationship behave in a way that the qualifying criterion (particularly the effectiveness testing) is no longer met.

13. The need for rebalancing can be assessed based on the considerations outlined in paper 17A.

14. Hence, **expected hedge ineffectiveness** (ie up to the originally[1] expected level resulting from the anticipated sources of ineffectiveness) does not require an

[1] Or—for a previously rebalanced hedging relationship—that expected after rebalancing.

adjustment of the hedging relationship and hence no rebalancing. This ineffectiveness has formed part of the decision-making process when the hedging relationship was initially designed and hence the hedge still performs as expected. Consequently, the impact is reflected as part of the *measurement* of ineffectiveness of a *continuing* hedging relationship.

15. Conversely, changes to the hedging relationship resulting from *unanticipated* levels or sources of ineffectiveness (**unexpected hedge ineffectiveness**) require an adjustment to the hedging relationship, ie a 'design change'. These levels or sources of ineffectiveness have not been taken into account for the purpose of decision-making and are detected only later on, eg by risk management as part of their ongoing monitoring of the purpose and effectiveness of the hedging relationship. Because that ineffectiveness goes beyond what anticipated the hedge no longer performs as expected. Hence, the hedging relationship has to be adjusted.

16. The adjustment of the hedging relationship raises the question which **type of adjustment** applies:

    (a) rebalancing, ie a change to a *continuing* hedge accounting relationship; or

    (b) discontinuation of the hedging relationship (which means that the adjustment would only be considered in a new hedge accounting relationship—a restart—but not 'save' the original hedge accounting relationship).

17. This, in turn, raises the question whether the type of adjustment depends on the **type of unexpected hedge ineffectiveness**:

    (a) Unexpected levels of ineffectiveness arising from anticipated sources going beyond the levels of fluctuation envisaged by risk management (covered in agenda paper 17C).

    (b) Ineffectiveness from unexpected sources not previously envisaged by risk management as potential causes of ineffectiveness. For example, the sharp widening in the basis between two currencies that historically have been stable (eg the widening of the basis of the USD against the Euro and the pound when pricing cross-currency interest rate swaps) or the change in the nature of the basis difference between crude oil and natural gas as more liquid natural gas markets develop in some locations with the consequence that the price link between natural gas in those locations and crude oil weakens or breaks.

18. Rebalancing is appropriate when risk management continues to hedge the original exposure using the original hedge cover[2] (including modifications) and updates the hedging relationship to reflect new information. These situations are best reflected by accounting for a continuation of an existing hedging relationship.

19. Hence, the notion of rebalancing does not depend on the type of unexpected hedge ineffectiveness but instead on whether the original risk management objective of the hedge still applies.

20. Conversely, if the unexpected hedge ineffectiveness is of such a magnitude that the adjustment represents an overhaul of the existing hedging relationship (including the original risk management objective), rebalancing is not appropriate and this would be treated as a discontinuation of the hedging relationship. The hedging relationship after the overhaul would then have to be assessed against the qualifying criteria and if they are met hedge accounting would be achieved in a new hedge accounting relationship.

What are the types of rebalancing?

21. There two **types of rebalancing**:

    (a) compulsory rebalancing, and

    (b) voluntary rebalancing.

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[2] Rollover strategies mean that the instruments that have been rolled are original hedges.

22. Compulsory rebalancing is driven by failing the qualifying criteria. It arises when unexpected sources of ineffectiveness cause an imbalance in the hedging relationship that fails the qualifying criteria and therefore the entity must rebalance in order to continue that hedging relationship.

23. Conversely, voluntary (proactive) rebalancing is an adjustment of the hedging relationship because risk management expects that the relationship will fail the qualifying criteria. For example, if the level of ineffectiveness is still within the expected magnitude but there is a trend emerging that suggests it will further increase or remain at an increased level rather than decrease again in line with previously experienced fluctuations.

24. In the context of rebalancing the question is whether the differentiation between these types of rebalancing would make a difference and hence be relevant.

25. The staff consider that voluntary rebalancing should not be precluded because the objective is to ensure that the hedging relationship will continue to qualify (ie the adjustment aims at reducing the likelihood of failing the qualifying criteria). Hence, such proactive adjustments are consistent with the objective of the effectiveness testing as described in paragraph 8.

26. The staff also note that in the context of this new objective-based effectiveness test the exact delineation between the two types of rebalancing (voluntary and compulsory) would be difficult. However, since both types of rebalancing are consistent with the objective of the new effectiveness test a differentiation between them is neither necessary nor meaningful.

Implications for hedge accounting

27. The staff believe that including the notion of rebalancing in the hedge accounting model allows entities to better reflect the economics of the hedging relationships and risk management. In many cases it also avoids the issues preparers face with the current model (particularly the discontinuation and restart as described in paper 17A).

Staff recommendation and question to the Board

28. Based on the analysis above, the staff propose that:

    (a) the new hedge accounting model should include rebalancing as mechanism to reflect adjusted hedges that are a continuation of existing hedging relationships.

    (b) rebalancing does *not* depend on the type of unexpected hedge ineffectiveness but instead on whether the original risk management objective of the hedge still applies. This also best reflects the new objective-based effectiveness test.

    (c) voluntary rebalancing should be *allowed*. This is consistent with the objective of the new effectiveness assessment approach.

Question - Rebalancing and Reassessment of the hedge ratio
Does the Board agree with the staff's recommendation as outlined in paragraph 28? If the Board disagrees with the staff recommendation, how would the Board like to proceed and why?

Appendix A – Summary of the Board's tentative decision at the 24 August 2010 meeting

A1 The objective of the effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and minimise expected ineffectiveness. Thus, for accounting purposes hedging relationships should not reflect a deliberate mismatch between the weightings of the hedged item and of the hedging instrument within the hedging relationship.

A2 In addition, hedging relationships are expected to achieve offsetting of changes between the hedged item and the hedging instrument that are attributable to the hedged risk (other than accidental offsetting).

A3 The assessment is forward looking and is performed at inception and on an ongoing basis.

A4 The type of assessment (quantitative or qualitative) depends on the relevant characteristics of the hedging relationship and on the potential sources of ineffectiveness. The main source of information to perform the effectiveness assessment is entities' risk management.

A5 No particular methods for assessing hedge effectiveness are prescribed. However, the method used should be robust enough to capture the relevant characteristics of the hedging relationship including the sources of ineffectiveness.

A6 Changes in the method for assessing effectiveness are mandatory if there are unexpected sources of ineffectiveness (ie new sources not initially anticipated), or if, upon a rebalancing in the hedging relationship, the method previously used is no longer capable of capturing the sources of ineffectiveness and is therefore now not capable of demonstrating whether the hedge produces an unbiased result and minimises ineffectiveness.