Project: **Financial Instruments (Replacement of IAS 39)—Hedge accounting**

Topic: **Eligibility of 'cash instruments' that are not at fair value through profit or loss as hedging instruments**

Introduction

Background

1. This paper is one of a series of papers that address the issue of the eligibility of non-derivative financial instruments (cash instruments) as hedging instruments.
2. This paper addresses whether the eligibility of cash instruments as hedging instruments should be extended to those cash instruments that are not measured at fair value through profit or loss (when hedging risks other than foreign exchange risk[1]).
3. 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.
4. This paper contains one question to the Board.

Summary of the comment letters and outreach

5. The comment letters and the outreach confirmed the overwhelming support for the proposals in the exposure draft (ED).
6. Out of 154 responses to this question nearly all either fully or conditionally agreed with the proposals.

[1] In accordance with IAS 39.72 cash instruments are eligible as hedging instruments for a hedge of foreign exchange risk.

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.

7. Respondents who agreed with the proposals felt that the extension of the eligibility criteria to cash instruments at fair value through profit or loss would provide a better representation of entities' risk management activities in the financial statements.

8. These respondents also welcomed the change in the focus that the ED brought into the hedge accounting model in relation to hedging instruments. This has been traditionally biased towards the definition of a derivative and artificially discriminated valid hedging strategies on the basis of the type of instruments used as hedging instruments.

9. The hedge accounting outreach was particularly helpful in enabling staff to further investigate the extent to which entities use cash instruments for hedging in practice, an issue that the Board expressed interest in even prior to publication of the ED. The outreach confirmed that there is a practical need to allow cash instruments to be used as hedging instruments not just for hedging of foreign currency exposures. The proposals were felt to be particularly useful in countries in Asia, South America, Middle and Far East where there are legal and regulatory restrictions on the use and availability of derivatives.

10. Respondents who conditionally agree with the proposals raised different aspects for clarification or amendment of the proposal, sometimes based on conflicting views.

11. Some of these respondents argue that there is no conceptual basis to restrict the use of cash instruments to those that are measured at fair value through profit or loss. In their view all cash instruments should be available for use as a hedging instrument. For them, the fact that instruments that are measured at amortised cost or at fair value through other comprehensive income (OCI) are not available as eligible hedging instruments will preclude entities from representing in the financial statements some of their risk management activities that use cash instruments. They viewed this as being inconsistent with the stated objective of the new hedge accounting proposals.

12. While others agreed with the general proposal to expand hedging instruments to include cash instruments measured at fair value through profit or loss they thought that the Board was not restrictive enough particularly in relation to cash instruments that are measured at fair value through profit or loss following the application of the fair value option. In these respondents' view the Board should

specifically restrict the use of cash instruments designated under the fair value option as these have usually been elected to be measured at fair value to eliminate an accounting mismatch and hence should not be within the scope of hedge accounting.

13. In relation to the fair value option some of the respondents who conditionally agreed also asked the Board to clarify whether financial liabilities that are measured at fair value with the changes in the fair value attributable to the own credit risk recognised in other comprehensive income would be eligible hedging instruments under the proposals.

14. Very few respondents disagreed with the proposals on cash instruments. Those that did disagreed either because they were unaware of hedging strategies using cash instruments measured at fair value through profit or loss or because they believed that the criteria should be the same for all cash instruments (and therefore opening the possibility just of one type of cash instruments would be inappropriate).

15. Finally, some respondents asked the Board to consider the eligibility of cash instruments that are not at fair value through profit or loss in the context of hedging the asset/liability profile by insurers.

16. In order to address the comments received, the staff will be presenting to the Board the papers mentioned in the cover paper. This paper addresses the eligibility of cash instruments at amortised cost and the second paper in this series addresses the interaction between the eligibility criteria for cash instruments and the fair value option.

Staff analysis

The issue

17. Should the eligibility as hedging instruments be extended to cash instruments that are not measured at fair value through profit or loss (when hedging risks other than foreign exchange risk[2])?

The proposals in the ED

18. The exposure draft proposes extending the eligibility as hedging instruments to non-derivative financial instruments measured at fair value through profit or loss.

19. This would remove the existing restriction *only* for those cash instruments that are accounted for at fair value through profit or loss. This would result in a requirement that (derivative and non-derivative) financial instruments classified as fair value through profit or loss *or* other cash instruments if hedging foreign exchange risk are eligible as hedging instruments.

20. The main argument for limiting the extension to cash instruments accounted for at fair value through profit or loss is as follows.

Financial instruments at amortised cost

21. The Board considered that extending the eligibility criteria to non-derivative financial instruments that are measured at fair value through profit or loss would not give rise to issues related to changes in the measurement basis.

22. In contrast, extending the eligibility to all cash instruments would mean that the measurement of a *hedging instrument* would have to change for those classified as amortised cost. In addition, the Board considered that the only way to mitigate this issue was to allow a componentisation of the cash instrument, which would limit the change in measurement to a component of the instrument

[2] In accordance with IAS 39.72 cash instruments are eligible as hedging instruments for a hedge of foreign exchange risk.

attributable to the hedged risk. However, this would require consideration of components of items in the scope of other standards and hence a significant expansion of the hedge accounting project[3].

23. For non-derivative financial instruments measured at amortised cost the main issue is whether the eligibility of these instruments can be discussed in isolation or needs to be analysed in the light of the broader conceptual issue of the classification and measurement model in IFRS 9 *Financial Instruments*. This is analysed further below.

Financial instruments at fair value through OCI

24. The Board proposed excluding equity investments measured at fair value through OCI from the scope of hedge accounting on the basis that their fair value changes never affect profit or loss.

25. The redeliberations of this proposal will be part of the discussion of the objective of hedge accounting (see agenda paper 8). Depending on the outcome of that discussion the Board might want to re-evaluate whether these instruments should also be eligible as hedging instruments. In that case the staff will bring an analysis of that issue to the Board.

Financial liabilities at fair value for which the effect of changes in credit risk is recognised in OCI

26. The eligibility as hedging instruments of financial liabilities that are accounted for at fair value and for which the effect of changes in credit risk is recognised in OCI is addressed in agenda paper 10B.

Interaction with classification and measurement

27. As mentioned in paragraph 22 above, there is a cross-cutting issue that needs to be considered when evaluating the extension of the eligibility as a hedging

[3] For hedges of foreign currency risk in accordance with the ED the situation is different because there is a deemed risk component that is determined in accordance with a specific standard—IAS 21 The Effects of Changes in Foreign Exchange Rates. Because this risk component is determined in accordance with a specific standard it is readily available to be incorporated by being referenced in the financial instruments standard. Consequently, this would not require separate additional requirements for risk components within the hedge accounting model.

instrument to instruments that are measured at amortised cost. That issue is the change to the measurement basis of the instrument upon start and discontinuation of hedge accounting.

28. The proposals in the current ED require a cash instrument to be measured at fair value through profit or loss in order for it to be an eligible hedging instrument, ie the instrument needs to be eligible for that measurement *in accordance with IFRS 9*. Extending the eligibility to cash instruments that would otherwise be measured at amortised cost in accordance with IFRS 9 would result in the hedge accounting model changing the measurement of such hedging instruments that would otherwise result from applying IFRS 9.

29. If the proposed eligibility is expanded to accommodate the request made by some respondents to include instruments measured at amortised cost it would raise several issues and potential complexity, particularly in the context of the interaction between the eligibility as hedging instruments and classification and measurement under IFRS 9.

30. If a cash instrument at amortised cost is considered to be an eligible hedging instrument, but upon designation the entire instrument or a component of it needs to be remeasured at fair value, a difference between the fair value and amortised cost will arise. (The only exception will be if the instrument is designated upon initial recognition, but other issues will arise upon discontinuation and rebalancing; see paragraph 33 below.) Hence, this would require the Board to define how to account for the difference between the fair value and the amortised cost of the hedging instrument upon designation.

31. This is similar to the scenario arising on some types of reclassification between measurement categories under IAS 39 *Financial Instruments: Recognition and Measurement*, which has proved to be a difficult area and adds complexity to the measurement requirements.

32. Upon discontinuation of the hedging relationship, the measurement of the cash instrument will revert to amortised cost (consistent with its original measurement basis under IFRS 9). Hence, there will a difference between its carrying amount as of the date of discontinuation (the fair value as at the discontinuation date which becomes the new deemed cost) and its amortised cost. This difference needs to be amortised over the remaining life of the instrument, using a revised effective interest rate. These are the mechanics used

in the reclassification provisions in IAS 39 which have proved to be operationally difficult to apply.

33. The issue above is exacerbated by the fact that based on the proposals in the ED a hedging relationship might be rebalanced as a result of failing the objective of the hedge effectiveness assessment (ie adjusting the hedge ratio). The possibility of rebalancing brings up the issue of partial discontinuation (ie for part of the volume of the hedging instrument).

34. Upon partial discontinuation of the volume of the hedging instrument, there will be a potential need for tracking the various discontinued volumes separately and to maintain a record of different effective interest rates at different periods for different volumes of the same non-derivative instrument. This will add significant complexity.

35. In addition, those volumes that have been subject to discontinuation can later be designated again as hedging instruments in other hedging relationships, which means that the revised amortised cost will generate yet another difference to the fair value at the point of designation.

36. The possibility of designating cash instruments at amortised cost as a hedging instrument has the consequence of:

    (a) constantly adjusting the measurement basis of the *hedging instrument* for as long as it is designated in a hedging relationship; and

    (b) on discontinuation of hedge accounting needing to change the measurement basis from fair value back to amortised cost, which requires to amortise previously recognised fair value adjustments.

37. This means that the hedge accounting model would not only change the measurement basis of the hedged item as occurs today but also that of hedging instruments. Hence, it could for example result in situations where a natural hedge (accounting *match*) is achieved on an amortised cost basis between two cash instruments but still hedge accounting could be used to change the measurement basis of both instruments to fair value (one as a hedged item and the other as the hedging instrument).

38. This would blur the lines between the amortised cost and fair value measurement categories and hence might undermine amortised cost as a measurement basis under IFRS 9. This would also be confusing for users of the

financial statements that could face a continuous change of the measurement basis of financial instruments. This would make it difficult for users to understand the carrying amounts of cash instruments used as hedging instruments. The ED already proposes changes in disclosure to help users understand the carrying amount of the hedged items—similar disclosures would probably be needed for hedging instruments if these changes were introduced and those disclosures would likely need to be extensive.

39. Finally, if a non-derivative financial asset or liability measured at amortised cost were allowed to be designated as a hedging instrument on a risk component basis, this would mean that:

    (a) there would still be a change to the measurement basis (albeit for a smaller item—the component) but in order for this issue to be operationalised the Board would in addition need to develop an approach for the componentisation of *hedging instruments*;

    (b) the financial instrument (as a whole) would be measured at an amount that is neither fair value nor amortised cost.

40. Hence, it would create additional issues in the understanding of the carrying amounts of such cash instruments when used as hedging instruments.

Staff recommendation

41. The staff consider that developing an approach for the componentisation of *hedging instruments* would take considerable time or/and result in a discussion of separating embedded derivatives. Hence, the staff consider that realistically the Board has only the following two alternatives:

    (a) **Alternative A**—Keep the eligibility criteria as proposed in the exposure draft and therefore (for hedges other than foreign exchange risk) only allow cash instruments that are measured at fair value through profit or loss to be eligible as hedging instruments.

    (b) **Alternative B**—Extend the eligibility criteria to non-derivative financial assets and non-derivative financial liabilities measured at amortised cost as a whole (when hedging risks other than foreign exchange risk).

42. Before coming to the staff recommendation the staff will weigh the pros and cons of each one of the alternatives.

Alternative A

Pros

(a) It is consistent with (and relies upon) the classification and measurement model in IFRS 9.

(b) It will not increase complexity because it will not require overriding the measurement basis upon designation and there is no need for amortisation of differences between the carrying amount upon discontinuation and the par amount.

(c) Based on the feedback received, the solution in the exposure draft addresses the majority of the hedging strategies using cash instruments when hedging risks other than foreign exchange risk. Hence, this alternative would be consistent with the vast majority of responses received on this proposal.

Cons

(a) The Board will not be taking a comprehensive review of the eligibility criteria for cash instruments that would include the possibility of componentisation of hedging instruments.

(b) The Board will not be addressing the concerns raised by some respondents who would like to have the ability to have wider qualification criteria for cash instruments as hedging instruments.

Alternative B

Pros

(a) It will address the concerns of some of the respondents.

Cons

(a) Even if achieved, this alternative will still not be a comprehensive review of the qualification criteria because it would not include risk components for *hedging instruments*.

(b) It would blur the lines between the amortised cost and fair value measurement categories and hence might undermine amortised cost as a

measurement basis under IFRS 9. This would also be confusing for users of the financial statements that could face a continuous change of the measurement basis of financial instruments.

(c) It would add significant additional complexity to the hedge accounting requirements and likely necessitate an extension of disclosure requirements to assist the understanding of users of the financial statements.

43. Based on the pros and cons above, the staff recommend alternative A

Question—Cash Instruments as hedging instruments
Does the Board agree with the staff recommendation in paragraph 43? If not, what would the Board prefer and why?