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

Topic: **Eligibility of 'cash instruments'—Interaction with the fair value option**

## Introduction

### *Background*

1. This is one paper in a series of papers that address the issue of eligibility of non-derivative financial instruments (cash instruments) as hedging instruments.
2. This paper addresses whether the fact that a non-derivative financial asset or non-derivative financial liability is accounted for at fair value through profit or loss as a consequence of applying the fair value option should have an influence on the eligibility criteria for cash instruments.
3. For the purposes 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 designation of cash instruments that are measured at fair value as a result of the application of the fair value option was one area where most of the respondents who conditionally agreed with the proposals on cash instruments asked for clarification from the Board.

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.

6. Some of the respondents thought that the Board was not restrictive enough in the proposals. In their view instruments designated as at fair value through profit or loss under the fair value option should not be eligible in some or all circumstances.

7. Within this group of respondents, there were some divergent views. While some expressed the view that cash instruments designated under the fair value option should be excluded from the eligibility as a hedging instrument because they are designated with the aim of eliminating or reducing an accounting mismatch, others thought that it should be possible to designate an instrument measured at fair value under the fair value option provided that such hedging instrument is designated in a fair value hedge.

8. Some respondents also thought that if the instruments under the fair value option are eligible hedging instruments the whole purpose of the fair value option would be defeated as application of hedge accounting would create a conflict between hedge accounting and the designation criteria under the fair value option (as by applying hedge accounting the item would not simply be measured at fair value through profit or loss as it would usually in accordance with the fair value option).

9. Other respondents simply asked the Board to clarify whether financial assets and financial liabilities designated under the fair value option would be eligible hedging instruments and whether there would be a difference between financial assets and financial liabilities. These respondents were concerned that for many financial liabilities designated as at fair value through profit or loss the fact that their changes in the fair value attributable to changes in the credit risk are recognised in other comprehensive income (OCI) would preclude them from being eligible hedging instruments.

## Staff analysis

***The issue***

10. Should the ability to designate a cash instrument as a hedging instrument be restricted by the fact that the cash instrument is at fair value through profit or loss as a result of the application of the fair value option?

***The proposals in the exposure draft (ED)***

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

***The fair value option in IFRS 9***

12. IFRS 9 *Financial Instruments* contains different provisions in relation to the designation of financial assets and financial liabilities under the fair value option[1].
13. For financial assets, entities may designate, irrevocably at initial recognition, a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains or losses on them on different bases.
14. For financial liabilities, the same designation criterion would apply, but the fair value option is also available in scenarios where
    (a) a group of financial liabilities or financial liabilities and financial assets is evaluated on a fair value basis in accordance with a documented risk management or investment strategy and information about the group is provided internally on that basis to the entity's key management personnel; or

[1] See paragraphs 4.1.5 and 4.2.2 (a) and (b) of IFRS 9.

(b) if the embedded derivative in a hybrid financial liability would otherwise be required to be separated.

15. Specifically, for financial liabilities designated at fair value under the fair value option, IFRS 9 requires that the changes in the liability's credit risk (commonly termed 'own credit') are presented in other comprehensive income (OCI) if this does not create or enlarge an accounting mismatch, while the remaining amount of the change in the fair value is presented in profit or loss. The change in the fair value attributable to the credit risk component of the liability is not subject to recycling to profit or loss[2] if recognised in OCI.

16. These provisions reflect one aspect of the asymmetrical classification and measurement model in IFRS 9 that has different classification and measurement provisions for financial assets and financial liabilities. While the classification of financial assets follows an approach based on the entity's business model and contractual cash flow characteristics, financial liabilities are by definition measured at amortised cost (either as a whole or as a result of bifurcation) unless they are held for trading or designated as at fair value through profit or loss under the fair value option (refer to paragraph 14 above).

17. Another important consideration in the context of the fair value option is that it is mainly designed with the aim of eliminating accounting mismatches generated by the mixed measurement model.

18. In the staff's view this is the overarching issue that needs to be discussed in order to address the concerns expressed in the comment letters and the outreach on this point. Hence, the discussion in this paper is focused on whether the application of hedge accounting undermines the concepts underlying the fair value option. To perform this analysis, the paper includes:

    (a) Analysis of the relationship between the architecture of the hedge accounting model and the fair value option.

[2] See paragraphs 5.7.7 and B 5.7.9 of IFRS 9.

(b) Analysis of the implications for fair value, cash flow and net investment hedges.

(c) Analysis of the effect upon the eligibility criteria for financial assets and liabilities designated under the fair value option.

***Relationship between hedge accounting and the fair value option***

***A—Accounting mismatch***

19. Similarly as in the current hedge accounting model, the proposed model is based on the notions of fair value hedging, cash flow hedging and hedging of a net investment in a foreign operation, which have different mechanics. These mechanics have an effect upon the way in which the hedging instrument is accounted for in the financial statements upon designation. In the staff's view, they are also affected by the assumptions underlying the fair value option.

20. This effect results from the fact that the application of hedge accounting brings back into the financial statements the mismatches that the fair value option tries to eliminate and hence contradicts the basis (qualifying criterion) on which the fair value option is commonly elected. Hence, if the cash instrument was designated as a hedging instrument in these circumstances there would be a conflict in the purposes of the fair value option and hedge accounting as they could not be achieved at the same time but instead would overall result in another accounting mismatch. Therefore, designating the cash instrument as a hedging instrument in these circumstances would call into question the legitimacy of electing the fair value option and be inappropriate.

21. Some may say that a specific prohibition of the eligibility might be needed. However, simply adding a prohibition to the eligibility criteria would not solve this issue as one of the elements underlying the fair value option might be sold or terminated at a later stage (ie the circumstances that made the fair value option available can disappear later on). Because the fair value option is irrevocable it would mean a cash instrument for which the fair value option was elected could never qualify even if there was no longer a conflict between the purposes of the fair value option and hedge accounting. This would not allow the use of hedge accounting at a later stage even when hedge accounting might mitigate an accounting mismatch without thereby creating another one regarding the fair value option election (because of the change in circumstances since that election).

22. The section below outlines the reasons for this view. These differentiate the three categories of hedges within the hedge accounting model.

*Cash flow hedges*

23. For a cash flow hedge the lower of the cumulative gain or loss on the hedging instrument from the inception of the hedge and the cumulative change in the fair value (present value) of the hedged item from the inception of the hedge is recognised in other comprehensive income.

24. When a cash instrument that has previously been designated under the fair value option is included in a cash flow hedge relationship, the accounting for the cash instrument under the fair value option needs to be overridden, because all (or part) of the changes in the fair value of that hedging instrument are recognised in other comprehensive income.

25. This has a serious impact upon a fundamental purpose of the fair value option, *which is to generate an offsetting change in profit or loss* between two instruments with different measurement bases. This is because the requirement to account for the change in the fair value of the cash instrument in other comprehensive income brings the mismatch that the fair value option tried to eliminate back into the financial statements. By applying cash flow hedge accounting by definition the accounting mismatch (in profit or loss) can no longer be eliminated or significantly reduced.

26. This scenario can also be compared to an in effect discontinuation of the fair value option that is artificially created by the application of hedge accounting. The fair value option is irrevocable. It would seem contradictory that another accounting mechanism creates an outcome that is forbidden under IFRS 9.

27. Hence, using a cash instrument as the hedging instrument in the circumstances described above is incompatible with the fair value option because of the mismatch that is left in the financial statements following the application of hedge accounting. Hence, provided that the original designation under the fair value option remains intact, the cash instruments should not be an eligible hedging instrument.

28. It is a different situation if the instrument(s) that created the accounting mismatch addressed by the fair value option is sold or otherwise terminated. In fact an entity may want to designate the instrument that is left (ie the one for which the fair value option was elected) into a new hedging relationship. In the staff's view that would be compatible with both the fair value option and hedge accounting. The purpose of the fair value option was to mitigate an accounting mismatch that has later on disappeared. If the cash instrument can then subsequently mitigate another accounting mismatch by using hedge accounting (given that the fair value option is irrevocable) it would be consistent with the rationale of having these means of addressing accounting mismatches.

29. On the basis of the arguments above, the staff consider that designating a cash instrument measured at fair value through profit or loss as a result of the application of the fair value option is inappropriate for a cash flow hedge if the fair value option was used to mitigate an accounting mismatch and as long as that original accounting mismatch that justified the fair value option continues to apply. Because of the strict provisions of the fair value option the staff do not consider that a specific prohibition needs to be added to the eligibility criteria for cash instruments as those requirements are clear..

30. The section below provides a similar analysis for net investment hedges and fair value hedges.

*Net investment hedges*

31. For net investment hedges, the effective part of the hedging relationship remains deferred in other comprehensive income until a recycling event as defined in IAS 21 *The Effects of Change in Foreign Exchange Rates* occurs.

32. Using cash instruments designated under the fair value option for net investment hedges is different from cash flow hedges in that the hedged risk is always foreign exchange risk and hence the related *risk component* of the *hedging instrument* is available for designation[3]. The foreign exchange risk component is determined in accordance with IAS 21.

33. Hence, in relation to the foreign exchange risk component, the issue of an accounting mismatch applies in the same way as for cash flow hedges.

34. However, for hedging *foreign exchange risk* the cash instrument would be available as the hedging instrument even if measured at amortised cost. Hence, in this situation there is no incentive for an entity to elect the fair value option solely in order to make the cash instrument available as a hedging instrument. In fact, achieving net investment hedging is easier using a cash instrument at amortised cost than a cash instrument at fair value through profit or loss. Hence, concerns about a potentially 'abusive' election of the fair value option are unwarranted.

*Fair value hedges*

35. In a fair value hedge a similar issue will arise because of the provisions underlying the fair value option.

36. Under the proposed mechanics[4] for fair value hedges, the change in the fair value of the hedged item is accounted for in other comprehensive income together with the change in the fair value of the hedging instrument. Ineffectiveness is then transferred to profit or loss.

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[3] See ED.B3.

[4] Even if the fair value hedge mechanics of IAS 39 were retained a mismatch would be created because the fair value hedge would change the accounting of a hedged item that without hedge accounting would not be measured at fair value through profit or loss. Hence, even though the fair value changes would be

37. This means that the amount recognised in profit or loss is not the change in the fair value of the hedging instrument, but instead the non-offsetting change between the fair value of the hedged item attributable to the hedged risk and the change in the fair value of the hedging instrument. This brings back the same issue as described for cash flow hedges above and hence the mismatch that the fair value option was trying to address is brought back into the financial statements.

38. This means, as in the case of cash flow and net investment hedges, that as a result of the application of hedge accounting the fair value option is artificially discontinued during the life of the hedging relationship, which is inconsistent with the fair value option.

***B—Fair value based management***

39. When the fair value option is elected because a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, that election is not related to an accounting mismatch. Hence, the concern that the use of hedge accounting could re-create the accounting mismatch that the election of the fair value option was intended to mitigate does not apply.

40. Moreover, when using the fair value option for financial instruments that are managed on a fair value basis this condition applies to a *group* of items and an entity must designate *all* eligible financial liabilities that are managed together as the group.[5] Hence, the fair value option cannot be used as an item by item choice with a view to achieving a desired hedge accounting outcome.

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recognised in profit or loss an accounting mismatch would still be re-created from the overall perspective.

[5] IFRS 9.B4.1.35.

### *C—Hybrid financial liabilities (avoiding bifurcation)*

41. When the fair value option is elected in order to avoid the bifurcation of a hybrid financial liability,[6] that election is also not related to an accounting mismatch.

42. This condition for the fair value option is very much circumstance driven, depending on the structure of the financial instrument. The qualifying criteria for electing the fair value option on this basis already include 'anti-abuse' provisions (ie that the embedded feature must be substantial and it is not obvious that it is closely related to the host contract).

43. Moreover, if the fair value option is not elected for such financial liabilities the embedded derivative would have to be separated and hence would be available as a hedging instrument. If an entity wants to achieve hedge accounting then separating the embedded derivative would facilitate a much more targeted hedging relationship using only that part of the hybrid liability that relates to hedging. Hence, concerns about a potentially 'abusive' election of the fair value option are unwarranted.

### *Conclusion*

44. As an overarching conclusion the staff consider that when a cash instrument is accounted for at fair value through profit or loss as a result of electing the fair value option the appropriateness of its use as a hedging instrument depends on the circumstances. Any designation as a hedging instrument must not contradict the entity's election of the fair value option.

45. The staff consider that the *proper* application of the fair value option and hedge accounting requirements, which takes into account their respective purposes, results in the appropriate use of those cash instruments as hedging instruments. Also, a general prohibition to designate as hedging instruments cash instruments that are accounted for at fair value through profit or loss as a result of electing the fair value option would be

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[6] IFRS 9.4.3.5.

inappropriate (as it would not differentiate circumstances and hence eg preclude the ability to designate such instruments at a later stage).

46. Hence, the staff consider that an explicit prohibition is neither needed nor appropriate. However, there is an additional angle to this question that is explored below.

***Distinction between financial assets and liabilities designated under the fair value option for the purpose of the eligibility as a hedging instrument***

47. In the comment letters and during the outreach, some respondents asked whether financial liabilities that are designated at fair value through profit or loss would be eligible hedging instruments under the proposed eligibility criteria for cash instruments.

48. This question is based on the fact that if a financial liability is designated as at fair value through profit or loss, the change in the fair value attributable to the own credit risk is normally accounted for in other comprehensive income. These changes are non-recyclable and will never affect profit or loss[7].

49. IFRS 9 (as issued in 2010) states that an entity shall present the gain or loss on a financial liability designated as at fair value through profit or loss in the following way[7]:

    (a) The amount of the change in the fair value that is attributable to changes in the credit risk of the liability shall be presented in other comprehensive income.

    (b) The remaining amount of the change in fair value shall be presented in profit or loss.

50. This provision is overridden if this accounting would create or enlarge an accounting mismatch in profit or loss. Under such circumstances the effects of changes in the credit risk of the liability are presented in profit or loss. The concept of an accounting mismatch in this scenario was a very specific one. The Board was aware of only one example at the time of

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[7] Refer to paragraphs 5.7.7 and 5.7.8 of IFRS 9 (as issued 2010).

introducing this requirement in IFRS 9. In most cases it is therefore expected that liabilities measured at fair value under the fair value option will recognise changes in fair value attributable to own credit in OCI.

51. For financial liabilities measured at fair value under the fair value option in IFRS 9, typically the change in fair value due to changes in own credit is recognised directly in OCI. If however the recognition of changes in fair value attributable to own credit would give rise to an accounting mismatch the entire change in fair value is recognised in profit or loss.

52. IFRS 9 refers to liabilities for which the fair value option is elected as 'liabilities designated at *fair value through profit or loss*'[8] irrespective of whether effects of changes in the liability's credit risk are recognised in OCI or profit or loss.

***Should an exception be considered in the context of financial liabilities that are designated at fair value with changes in the fair value attributable to the own credit risk component recognised in OCI?***

53. Some asked the Board to explicitly clarify whether liabilities that are subject to the fair value option but for which a portion of the fair value change is required to be recognised in OCI would still be eligible hedging instruments.The staff do not consider that these financial liabilities should be eligible as hedging instruments for the following reasons:

    (a) The credit risk component is a source of hedge ineffectiveness and if this designation was allowed it would result in hedging relationships that exclude credit risk (of the hedging instrument) from the hedging relationship if the designation was based on *only* the part of the liability that is measured at fair value through profit or loss.

    (b) Conversely, if the designation was based on the entire fair value change of the liability (ie including the effect of changes in the credit risk of the liability) then the non-recycle OCI classification of the credit risk related changes in the fair value of the liability under the

[8] IFRS 9 paragraphs 4.2.2 and 5.7.7.

fair value option would have to be overridden in order to comply with the hedge accounting requirements.

54. Therefore, the staff consider that the proposals in the ED should be clarified to specifically prevent financial liabilities for which the effect of changes in the credit risk is recognised in OCI being eligible as hedging instruments. Only those cash instruments for which the *entire* change in fair value is recognised in profit or loss should be eligible as hedging instruments.

## Staff recommendation

55. As mentioned earlier in the paper, in the staff's view the major issue to be addressed is whether the eligibility of cash instruments as hedging instruments is incompatible with the designation under the fair value option also on the basis of so-called accounting mismatches.

56. On the basis of the analysis above, the staff consider that the fair value option provisions *can* be compatible with the designation of cash instruments, depending on the circumstances. This follows from the direct application of the principles stated in the ED.

57. Even if there are changes to the circumstances that underpin the original fair value option designation, if the cash instrument is a *liability*, then it is only eligible if *all* the changes in fair value are recognised in profit or loss.

58. Consequently, the staff consider that no specific prohibition in the eligibility criterion for cash instruments is needed or warranted but that the application to liabilities for which part of the fair value change is recognised in OCI should be clarified to specify that liabilities under the fair value option with the effects of changes in own credit recognised directly in OCI be ineligible as hedging instruments.

| Question—Cash Instruments—interaction with the fair value option |
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| Does the Board agree with the staff recommendation in paragraph 58?<br><br>If not, what would the Board prefer and why? |