Project	**Financial Instruments (Replacement of IAS 39)—Hedge accounting**
Topic	**Hedged items—risk components: staff recommendations and questions to the Board**

Introduction

1. This paper is one in the series that addresses the designation of a *risk component* as the hedged item. This paper sets out the staff recommendations and questions to the Board.

Staff recommendations and questions to the Board

The notion of risk components as hedged items

2. The first question is whether the *notion* (as such) of risk components as eligible hedged items should be retained. The staff analysis for this question is in agenda paper 3A.[1]

3. The staff consider that the eligibility of risk components as hedged items is useful because it reflects the economic reality, ie that risk management typically operates on a 'by risk' instead of a 'by item' basis (which is the unit of account for financial reporting purposes). Hence, designation of hedged items on a risk components basis portrays the essence of the economic phenomenon if risk is managed for a risk component instead of an item in its entirety. Conversely,

[1] Specifically refer to paragraph 21 (however, agenda paper 3A as a whole illustrates this point more generally).

requiring that all hedged items are 'deemed' to be hedged in their entirety (ie for all risks) would not explain the hedging activities of an entity (at least not faithfully).

4. The staff also note that while there were requests for clarification, using the notion of eligible risk components as such was as good as uncontested in the feedback received.

5. In addition, the staff note that IAS 39 *Financial Instruments: Recognition and Measurement* has included the notion of eligible risk components for a long time for financial exposures and that it has worked in practice under IFRSs.

6. Hence, the staff recommend retaining the *notion* of risk components as eligible hedged items (the next questions address *how eligible risk components should be determined*).

Question 1: the notion of risk components as hedged items
Does the Board agree with the staff recommendation to retain the *notion* of risk components as eligible hedged items (ie the notion as such)? If the Board does not agree, what would the Board prefer instead and why?

Criteria-based approach to determining eligible risk components

7. If the Board agrees with the staff recommendation on Question 1, the next question is whether risk components should be determined based on *criteria* and if so, which criteria should be used.

8. The staff analysis for this question is in agenda paper 3B.[2] The staff note that:

[2] See paragraphs 3-7 of agenda paper 3B.

(a) There was overwhelming support in the feedback for using a criteria-based approach. In particular, the feedback emphasised that the use of criteria would facilitate that the requirements for determining eligible risk components are the same for *financial* and *non-financial* items and could hence overcome the bias against some types of risk components under IAS 39, which was considered to be arbitrary and conceptually not justifiable.

(b) Because of the large variety of markets and hence circumstances in which hedging takes place there is no viable alternative to using a criteria-based approach to identifying eligible risk components This ramification is amplified for the IASB as an *international* standard setter.

(c) Using the criteria proposed in the ED has the advantage of being already well established under IFRSs. The feedback also generally supported using those criteria.

9. Hence, the staff recommend using a *criteria-based approach* to determining eligible risk components on the basis of the criteria proposed in the ED, ie that a risk component must be *separately identifiable and reliably measureable*.

Question 2: criteria-based approach
Does the Board agree with the staff recommendation to use a *criteria-based approach* to determining eligible risk components on the basis of the criteria proposed in the ED, ie that a risk component must be *separately identifiable and reliably measureable*? If the Board does not agree, what would the Board prefer instead and why?

Applying the same criteria for financial and non-financial items

10. If the Board agrees with the staff recommendation on Question 2, the next question is whether the criteria should apply *for all types of items*, ie risk components of financial *and non-financial* items.

11. The staff analysis for this question is agenda paper 3A—that paper compares and contrasts risk components of financial and non-financial items. Some additional considerations are included in agenda paper 3B.[3] The staff note that:

    (a) There was general support for using the criteria proposed in the ED as a single set of criteria. Also, as mentioned before, a common theme of the feedback was that the criteria should be the same for *financial* and *non-financial* items.

    (b) The analyses in agenda paper 3B demonstrate that there is no sound basis for using different criteria for financial and non-financial items. The relevant issue is the familiarity with various markets instead of a difference between financial and non-financial items. The large variety of markets and hence circumstances in which hedging takes place makes it impossible for any one person to understand all of them. But the fact that some might not be as familiar with markets for non-financial items as with those for financial items does not mean that markets for non-financial items are generally a less appropriate context for determining risk components.

    (c) The criteria proposed in the ED have to be assessed in the context of the particular market structure to which the risk relates and in which the hedging activity takes place. Hence, the *analysis of the market structure is crucial for determining eligible risk components*.[4] The market structure dictates the parameters for determining eligible risk components and ensures they cannot be simply imputed. The

[3] See agenda paper 3B, paragraphs 5-7.
[4] See agenda paper 3A, paragraph 52.

requirement as well as the feasibility to analyse the market structure applies to markets for financial and non-financial items alike.

12. Hence, the staff recommend using a single set of criteria for all items, ie that the criteria should apply *for all types of items*—risk components of financial *and non-financial* items.

Question 3: single set of criteria for all items
Does the Board agree with the staff recommendation to use a single set of criteria for all items, ie that the criteria should apply *for all types of items*—risk components of financial *and non-financial* items? If the Board does not agree, what would the Board prefer instead and why?

Guidance to be provided for the application of the criteria

13. If the Board agrees with the staff recommendation on Question 3, the next question is what guidance should be provided for the application of the criteria.

14. The staff analysis for the type and extent of the guidance to be provided is set out in agenda paper 3B.[5] The staff consider that the guidance for the final requirements should demonstrate the analysis required to conclude that a risk component is eligible for designation as a hedged item. Hence, it should use examples that illustrate *how to apply* the criteria (rather than only the outcome, ie *whether* there is an eligible risk component). The staff's rationale for selecting the examples and the key features they illustrate are set out in more detail in agenda paper 3B.[6]

[5] See agenda paper 3B, section 'Guidance to be provided for the application of the criteria' (paragraphs 8-15).
[6] See agenda paper 3B, section 'Examples demonstrating the application of the criteria' (paragraphs 41-48).

15. Against the background of the general considerations for selecting the guidance and the examples provided as part of the comment letters the staff recommend:

    (a) That guidance on how to apply the criteria should be provided using the following examples:

        (i) Commodity price risk related to coffee purchases.

        (ii) Price risk related to jet fuel purchases.

        (iii) The fair value interest rate risk of a fixed rate bond.

    (b) That the example in the ED regarding the contractually specified risk components in a natural gas contract should be retained (but that no expansion of that example is needed).

    (c) That the 'sub-LIBOR' example in the ED[7] should be expanded by including an example of a commodity hedge in order to illustrate that the issue applies in the context of a market for a non-financial item.[8]

Question 4: guidance to be provided for the application of the criteria
Does the Board agree with the staff recommendation to provide guidance using the examples set out in paragraph 15? If the Board does not agree, what would the Board prefer instead and why?

Inflation risk

16. The last question to the Board relates to inflation risk. The ED includes a specific restriction that prohibits designating as a hedged item *non-contractually*

[7] See ED.B24-26.
[8] See agenda paper 3B, section 'Negative spreads' (in particular paragraph 39).

specified inflation risk components of *financial* items.[9] This was specifically raised as an issue by the feedback on the ED.

17. The staff analysis of inflation risk as a risk component is set out in agenda paper 3B.[10] The staff consider that the alternatives for the Board are:

    (a) **Alternative 1**: Retain restriction as set out in the ED.

    (b) **Alternative 2**: Eliminate the restriction in the ED.

    (c) **Alternative 3**: Eliminate the restriction in the ED but add a 'caution' or 'rebuttable presumption' regarding non-contractually specified risk components of financial items.

    (d) **Alternative 4**: Change the outright prohibition in the ED by including an example of a situation in which an inflation risk component is eligible for designation as a risk component and an example of a situation in which inflation risk is not an eligible risk component.

18. The staff reiterate the trade-off between:

    (a) An outright prohibition, which means that even if inflation risk were separately identifiable and reliably measurable in a particular situation it would still not be an eligible risk component.

    (b) Sending the wrong signal to those who would conclude that by implication of removing the outright prohibition inflation risk would more generally be an eligible risk component—even if not supported by the market structure and not independently determined for the hedged item.

19. The alternatives present a spectrum between retaining the outright prohibition and removing it altogether. Because of the pros and cons for each alternative along this spectrum the staff consider that there is no sufficient basis to recommend one of them over the others.

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[9] See ED.B18.

[10] See agenda paper 3B, section 'Inflation risk' (paragraphs 50-63).

Question 5: inflation risk
Which of the alternatives for addressing inflation risk does the Board prefer and why? If the Board does not agree with any of the alternatives, what would the Board prefer instead and why?