Project	**Financial Instruments (Replacement of IAS 39)—Hedge accounting**
Topic	**Designating combinations of options as the hedging instrument**

Introduction

Background and purpose

1. In commenting on the exposure draft *Hedge Accounting* (ED), respondents have asked the Board to amend paragraph 11 of the ED, which relates to the restriction of designating a written option in combination with a purchased option as the hedging instrument. Participants from outreach activities have also asked for the same amendment.

2. The purpose of this paper is to ask the Board whether it wants to amend paragraph 11 of the ED, ie whether to align the hedge accounting requirement relating to designating combinations of options as the hedging instrument with that of designating collars. This paper contains one question to the Board.

3. Instead of entering into one collar contract, entities often enter into two separate option contracts that in effect achieve the economic outcome of a collar contract. Reasons are for example:

    (a) Stand-alone options are widely available on trading exchanges. Exchange traded options have the following benefits:

        (i) they are liquid; and

        (ii) credit risk is limited for exchange traded instruments.

    (b) For an over-the-counter trade, it can also be more cost effective for entities to enter into two separate options than a collar contract. Financial institutions often manage the two option elements in a collar differently. When a bank provides an entity with a collar it in effect ‘packages’ two options, which can affect the fee structure.

4. One aspect that is relevant for those differences is that ‘normal’ options involve credit risk only for the option holder (but not the option writer) whereas a collar involves credit risk for both parties (like eg for swaps).

Proposal in the ED

5. Paragraph 11 of the ED permits designating a derivative instrument (one single instrument) that combines a written option and a purchased option (eg a collar) as a hedging instrument if the combined effect of the two options is not a net written option. However, the ED *does not* permit two or more instruments to be designated as the hedging instrument if one of them is a *written* option or a net written option.

Feedback from comment letters and outreach activities

6. In the comment letter feedback to the ED, some commentators have asked the Board to amend the proposed requirements in paragraph 11 of the ED.

7. Respondents requested that paragraph 11 of the ED be amended such that stand-alone written options are not excluded from being eligible hedging instruments *if combined* with other designated hedging instruments (ie purchased options) they are not a *net* written option.

8. Respondents believe that the written option prohibition should only apply to the combined effect of the financial instruments designated as the hedging instrument, ie if that *combination* is a *net* written option (regardless of whether it results from one or several different contracts).

9. Participants in the outreach activities raised the same issue.

Staff analysis

10. The staff note that the proposal in the ED is the same as the requirement in IAS 39 *Financial Instruments: Recognition and Measurement* today. (See appendix A).

11. Under the ED and IAS 39 today, a written option does not qualify as a hedging instrument under any circumstances except for when it is used to hedge a purchased option[1] or unless it is combined with a purchased option as *one* derivative instrument (eg a collar) and the combined option is not net written[2].

12. Respondents noted that an entity can designate a collar contract (which consists of a written option and a purchased option in one contract) as a hedging instrument and qualify for hedge accounting if the net effect is not a net written option.

13. However, if the entity enters into a purchased option and a written option separately (ie two separate contracts) that taken together have the same terms as the collar contract, the entity cannot jointly designate them as two instruments even though the economic substance is similar to that of a collar contract. Entities cannot achieve hedge accounting under paragraph 11 of the ED (which is equivalent to paragraph 77 of IAS 39) because one of the instruments is a written option.

14. The staff consider that whether an option qualifies for designation as a hedging instrument should depend on its economic substance rather than legal form. So that the requirements are consistent with the economic outcomes, the staff are of the view that a stand-alone written option in combination with a purchased option should be eligible for joint designation as a hedging instrument if the combined effect of the two instruments is a not net written option.

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[1] Paragraph B4 of the ED and IAS 39.AG94.

[2] IAS 39.IG F.1.3 provides guidance on determining whether an interest rate collar or derivative instrument that combines a written option component and a purchased option component is not net written.

Staff recommendation and question to the Board

15. In finalising the new hedge accounting requirements, the staff recommend that the Board amend the requirement that a combination of a written and a purchased option (regardless of whether the hedging instrument arises from one or several different contracts) can be jointly designated as the hedging instrument *unless* that combination is a *net written* option.

16. The amendment would:

    (a) remove an exception regarding designating a combination of financial instruments as hedging instruments. IAS 39 and the ED permit jointly designating several derivative instruments with offsetting risk as a hedging instrument. Not allowing a written option to be jointly designated with a purchased option as the hedging instrument is an exception to that general requirement. By removing this exception, it reduces complexity.

    (b) align the accounting treatment with that of collars (which qualify as hedging instrument unless they are net written options). The accounting treatment would be consistent with the economic outcomes regardless of legal form resulting in a more logical and less arbitrary final IFRS. The staff consider that the evaluation of whether a combination of a written and a purchased option is a net written option would require considering the same aspects as the evaluation of whether a collar that combines a written and a purchased option component constitutes a net written option (which is required under IAS 39 today) and hence would be operational.

    (c) alleviate the pressure in current practice regarding the evaluation of whether two contracts should be accounted for as one or two instruments. Current practice faces the challenge of a judgemental evaluation whether two contracts should be accounted for as one financial instrument based on the guidance in IAS 39.IG B.6.

17. The staff note that the amendment **would not** change the prohibition that net written options (including stand-alone written options that are not jointly designated with purchased options or that after joint designation would still be a net written option) **cannot** qualify as eligible hedging instruments (except to hedge a purchased option).

Question:
Does the Board agree with the staff recommendation in paragraph 15 above? If the Board does not agree, what does the Board prefer instead and why?

Appendix A

A1. This appendix provides extracts of the ED and IAS 39.

A2. Extracts of the ED (paragraphs 11 and B4):

> 11 However, a derivative instrument that combines a written option and a purchased option (eg an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option. Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option.
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> B4 This [draft] IFRS does not restrict the circumstances in which a derivative may be designated as a hedging instrument, except for some written options. A written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability).

A3. Extracts of IAS 39 (paragraphs 77, AG94, IG B.6 and F.1.3):

> 77 … However, an interest rate collar or other derivative instrument that combines a written option and a purchased option does not qualify as a hedging instrument if it is, in effect, a net written option (for which a net premium is received). Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option.
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> AG94 The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. Therefore, a written option dos not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability). In contract, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposures from changes in fair values or cash flows. Accordingly, it can qualify a hedging instrument.

B.6 **Definition of a derivative: offsetting loans**

Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are no transfers of principal at inception of the two loans, since A and B have a netting agreement. Is this a derivative under IAS 39?

Yes. This meets the definition of a derivative (that is to say, there is an underlying variable, no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and future settlement). The contractual effect of the loan is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

- they are entered into at the same time and in contemplation of one another
- they have the same counterparty
- they relate to the same risk
- there is no apparent economic need or substance business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IAS 39.9 does not require net settlement.

F.1.3 **Issue (a) – Does IAS 39.AG94 preclude the use of an interest rate collar or other derivative instrument that combines a written option component and a purchased option component as a hedging instrument?**

It depends. An interest rate collar or other derivative instrument that includes a written option cannot be designated as a hedging instrument if it is a net written option, because IAS 39.AG94 precludes the use of a written option as a hedging instrument unless it is designated as an offset to a purchased option. An interest rate collar or other derivative instruments that includes a written option may be designated as a hedging instrument, however, if the combination is a net purchased option or zero cost collar.

Issue (b) – What factors indicate that an interest rate collar or other derivative instrument that combines a written option component and a purchased option component is not a net written option?

The following factors taken together suggest that an interest rate collar or other derivative instrument that includes a written option is not a net written option.

(a) No net premium is received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.

(b) Except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date). Also, the notional amount of the written option component is not greater than the notional amount of the purchased option component.