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

Topic: **Other than accidental offsetting—clarification**

Introduction

Background

1. This paper is one in a series of papers that addresses the feedback received on the proposals in the exposure draft *Hedge Accounting* (ED) regarding the hedge effectiveness assessment.
2. This paper addresses one criterion of the proposed hedge effectiveness requirements: 'other than accidental offsetting'. Question 6 in the invitation to comment relates to this issue.
3. This paper does not contain any questions to the Board. These will be asked in agenda paper 1C.

Overview of the proposal in the ED[1]

4. The ED proposes eliminating the 80-125 per cent 'bright-line' in IAS 39 *Financial Instruments: Recognition and Measurement* and replacing the combination of a prospective and a retrospective hedge effectiveness assessment with new prospective hedge effectiveness requirements that comprise two criteria—the hedging relationship:

[1] Refer to paragraphs 19(c) (ii) and B29 to B31of the ED (the proposals were addressed by agenda paper series 4 presented at the 24 August 2010 IASB meeting).

(a) must meet the objective of the hedge effectiveness assessment (ie it ensures that the hedging relationship will produce an *unbiased result* and *minimise expected hedge ineffectiveness*); and

(b) must be expected to achieve *other than accidental offsetting*.

Rationale for the proposals

5. The overall aim of the proposed hedge accounting model is to better align accounting with risk management (ie to move away from an artificial disconnected accounting exercise). This is particularly relevant for the hedge effectiveness assessment, which under IAS 39 is based on a purely accounting driven bright-line test (80-125 per cent range). That has resulted in a 'good hedge/bad hedge model' whereby the accounting threshold awards hedge accounting to 'good' hedges and bans it for 'bad' hedges—creating a complete disconnect from risk management.

6. Hence, the ED proposes replacing the bright-line test with a concept that aims to reflect the way entities look at the design and monitoring of hedging relationships from a risk management perspective. Inherent in this was the concept of '*other than accidental offsetting*'. It links the risk management perspective with the hedge accounting model's general notion of offset between gains and losses of hedging instruments and hedged items. It also reflects the intention that the effectiveness assessment should not be based on a particular level of effectiveness (hence avoiding a new bright-line).

7. By eliminating rather than just changing or softening bright-lines, the proposals facilitate entities exercising their professional judgement and linking their internal processes used for risk management purposes, and hence the information used for decision making, to hedge accounting.

Feedback from comment letters and outreach activities on effectiveness criteria

8. The responses in the comment letters and the feedback from the outreach activities showed overwhelming support for the removal of the 80-125 per cent quantitative test, which under the current model gives rise to arbitrary outcomes, and creates operational complexity and a big administrative burden.

9. There was also overwhelming support for avoiding the use of bright-lines in general and for the move towards a more principle-based effectiveness assessment. Commentators feel that under the current model in IAS 39, the very restrictive effectiveness assessment prevents entities portraying the results of their risk management by using hedge accounting.

10. In addition almost all commentators agreed with the removal of the retrospective test (whereby falling outside the 80-125 per cent range causes an entity to cease to qualify for hedge accounting) and were in favour of the possibility of applying a qualitative approach to effectiveness testing in some circumstances.

11. Although there was general support for the proposed hedge effectiveness requirements, many of the commentators asked the Board to provide further guidance on the concepts underlying the proposals because new concepts were introduced which many felt were not well understood. They requested additional guidance on the meaning of: 'other than accidental offsetting', 'unbiased result', 'minimisation of hedge ineffectiveness' and 'rebalancing' and they argued that it is essential that the Board clarifies these concepts to ensure consistent application of the model. A few of these respondents also argued that that such clarification would improve the rigour of the proposed model.

12. Some commentators, particularly some auditors and preparers, also asked the Board to consider whether moving towards a *qualitative threshold*, particularly the one suggested by the Financial Accounting Standards Board (FASB) in its proposals on accounting for financial instruments, would be something to consider with the aim of helping convergence between the IASB and the FASB. These commentators believe that in order to meet the hedge effectiveness criteria a hedging relationship should be required to be 'reasonably effective' in achieving offsetting changes in the fair value of the hedged item attributable to the hedged risk and in the fair value of the hedging instrument.

13. However, some of the auditors with this view, when responding to the FASB's proposals, raised concerns about the meaning and practical relevance of such a 'qualitative threshold'. Another concern was that such a threshold might not be operational and has the danger of inadvertently creating a new (or perpetuating the old) percentage-based bright-line test. There were auditors within this group that expressed the view that they hope that regulators would not use the qualitative measure as a mean to create a new quantitative threshold. Others

asked the FASB to better articulate the use of ‘reasonably effective’ with the possibility of doing a qualitative assessment in some circumstances.

14. Preparers provided mixed feedback when responding to the FASB. While some were reasonably comfortable with the move towards a qualitative threshold like ‘reasonably effective’ because they view it as a way of simplifying hedge accounting, others argued that if such a threshold is left on its own without any additional guidance, a quantitative proof of effectiveness will be required to make the model operational.

15. There was also a clear difference in the feedback by type of commentator. While treasurers and risk management professionals were more comfortable with the concepts underlying the new qualifying criteria, accountants were comparatively less comfortable and requested more guidance in order to apply those concepts.

16. The few commentators who disagreed did so for different reasons, such as:

    (a) Some were uncomfortable with the fact that the model relies on several new notions and does not provide enough guidance on how to apply them.

    (b) Some are of the view that the current quantitative threshold in IAS 39 is still appropriate.

    (c) Some are of the view that applying a fully principle-based model will generate operational difficulties and has the potential to inappropriately extend the application of hedge accounting and may have unintended consequences particularly the comparability of the financial statements.

Staff analysis

17. In the following analysis the staff consider what main issues result from the feedback and how they could be addressed.

Fundamental reform of the hedge effectiveness assessment

18. The staff note that most commentators agreed with a fundamental reform of the hedge effectiveness assessment in IAS 39, mainly for the following reasons:

    (a) eliminating bright-line tests;

(b) moving to a principle-based approach to assessing hedge effectiveness;

(c) linking the effectiveness assessment to risk management.

19. Hence, there is strong support for the direction of the proposals. Thus, the staff consider that the new hedge effectiveness assessment should retain the hedge effectiveness assessment concepts in the proposal.

Extent of guidance and clarification

20. The main issue that commentators raised was a request for more guidance or elaboration to clarify what the new terminology in the ED means. This relates to the different aspects or elements in the new terms in the ED, which are essentially *umbrella terms*.

21. The staff consider that the root cause of those requests for elaboration is the proposed change from the approach in IAS 39 that in effect *mingles different aspects* of the hedge effectiveness assessment in a *single percentage number* that is used for the bright-line test. While there are many disadvantages with this approach it has the benefit of simplicity in this respect—in a sense that one does not need to understand risk management well to calculate a number and apply the current 'rules'. This single number comprises the effects on the value of the hedging instrument and the hedged item of:

(a) changes in the underlyings of the hedging instrument and the hedged item (ie the economic relationship between the items);

(b) changes in the credit risk of the hedging instrument and hedged item; and

(c) the hedging relationship’s hedge ratio.

22. Other reasons for those requests are

(a) the proposed requirements are new, which by definition means people are unfamiliar with them;

(b) applying the proposals in the ED would require people to familiarise themselves much more with risk management than they need to for applying IAS 39;

(c) uncertainty about exercising judgement that naturally results from moving from a bright-line test—that has eliminated judgement by a quantitative assessment condensed in one number—to an assessment that can be qualitative in nature and hence involves judgement.

23. However, commentators also emphasised that any elaboration should *not* lead back to a bright-line or (mandatory) quantitative test—neither directly nor even by implication.

24. The staff consider that this feedback has the following implications for finalising the ED:

    (a) While the use of a single number appears simple this approach creates significant complexity in a different way—the computation of the number. As commentators noted, the quantitative test is a main cause for operational complexity and a big administrative burden particularly because it is not a test used for any purpose except accounting.[2] More importantly, commentators agreed that a bright-line test has inappropriate, arbitrary outcomes. Hence, they did not consider retaining this or similar approaches viable but instead supported a fundamental reform based on principles rather than bright-lines (see section 'Fundamental reform of the hedge effectiveness assessment').

    (b) Moving from an effectiveness assessment in which the relevant aspects are *implicit* in a single number to an effectiveness assessment that uses umbrella terms such as 'other than accidental offsetting' results in requirements that have a high degree of *abstractness*. This makes it more difficult for people to understand what the relevant aspects or elements of the assessment are, ie what to apply their judgement to.

25. Hence, the staff consider that the request for more elaboration can best be addressed by reducing the abstractness of the proposals. This means that the aspects implicit in the umbrella term need to be made explicit (ie disaggregated) to provide greater clarity and to facilitate a better understanding of what aspects are relevant when assessing hedge effectiveness.

26. However, in doing so care is required so that the elaboration does not result in an (albeit indirect) return to a bright-line approach. This would defeat the

[2] See paragraph 8.

purpose of the proposals (and raise additional concerns instead of address concerns from commentators).

27. Another ramification of the feedback is that any further *increase* in the abstractness of the requirements would not resolve but exacerbate the issue. Hence, the aspects of the effectiveness assessment must not be further aggregated or condensed (eg by using new umbrella terms).

28. The staff consider that disaggregating umbrella terms to reduce abstractness can address the main reason for the requests for elaboration.[3] However, the other reasons for elaboration, ie that people are unfamiliar with new requirements and the uncertainty about exercising judgement resulting from moving from a bright-line test to an assessment that involves judgement,[4] are inevitably associated with a major change. Hence, the staff consider those reasons will only be addressed as people apply the new requirements over time.

29. Based on the feedback received, disaggregating the umbrella term 'other than accidental offsetting' seems the best way of addressing the request for elaboration. A common suggestion by commentators was to directly refer to the aspect of the economic relationship between hedging instrument and hedged item and elevate it to the main text body of the document. The following section explores how the abstractness of the umbrella term 'other than accidental offsetting' could be reduced through disaggregation.

Disaggregating the umbrella term 'other than accidental offsetting'

30. The concept of '*other than accidental offsetting*' was intended to comprise two aspects:

    (a) the notion of an economic relationship between the hedged item and the hedging instrument during the life of the hedging relationship, which gives rise to offset; and

[3] See paragraph 21.
[4] See paragraph 22.

(b) the effect of credit risk on the level of offset between gains and losses on the hedging instrument and the hedged item that may reduce or modify the extent of offset.

31. The **first aspect** of the economic relationship means that the hedging instrument and the hedged item have values that generally move in opposite direction because of the same risk, which is the hedged risk. Hence, the value of the hedging instrument and the value of the hedged item must systematically change in response to either the same underlying or underlyings that are economically related such that they respond in a similar way to the risk that is being hedged (eg Brent and WTI crude oil). This is the basis for considering the value changes of the two items in contemplation of each other (ie together) and hence the basis for applying hedge accounting. This also means that the fact that statistical correlation exists is not, by itself, enough to demonstrate that an economic relationship exists.

32. For economic purposes entities often use analyses that are qualitative (rather than quantitative) to demonstrate that an economic relationship exists between hedged items and hedging instruments. This can occur for example when the hedged item and hedging instrument have an identical underlying. These depend upon how the exposures are hedged and upon other qualitative information that has been gathered for risk management purposes.

33. The **second aspect** of the effect of credit risk means that *even if* there is an economic relationship the level of offset might become erratic. This can result from a change in the credit risk of either the hedging instrument or the hedged item that is of a magnitude such that the credit risk dominates the value changes that result from the economic relationship (ie the effect of the changes in the underlying). A magnitude that gives rise to *dominance* is one where the loss (or gain) from credit risk would frustrate the effect of changes in the underlying on the value of the hedging instrument or the hedged item even if they were significant. Conversely, if during a particular period the underlying remains stable, the fact that even small credit risk related changes in the value of the hedging instrument or the hedged item might affect the value more than the underlying does not create *dominance*.

34. Since the hedge accounting model is based on a general notion of offset between gains and losses on *hedging instruments and hedged items* (not just the changes

in the underlyings) the effect of credit risk is part of the effectiveness assessment.

35. The staff consider that providing more elaboration would create the danger of indirectly returning to a bright-line approach. Instead of addressing concerns from commentators but re-create their main concern about the existing effectiveness assessment in IAS 39 and hence defeat the purpose of the proposals.[5]

Arguments cited for disagreement with the proposals

36. The staff consider that the concerns of those who disagreed because the proposals introduce new concepts without sufficient guidance how to apply them should be addressed by disaggregating the umbrella term 'other than accidental offsetting' (as contemplated earlier in this paper). To the extent that these concerns should in substance reflect a preference for a rules-based effectiveness assessment these commentators have a similar view as those commentators who do not support a fundamental reform of the hedge effectiveness assessment, which is fundamentally different from the direction that the Board has taken in the hedge accounting project.

37. Some commentators disagreed because they prefer a qualitative threshold of 'reasonably effective'. The staff have analysed the implications of using that threshold (see Appendix C to paper 1B). On that basis the staff consider that this suggested solution would create ambiguity rather than clarity and exacerbate concerns that many other commentators have raised. Hence, the staff consider that using this threshold would not improve the ED.

38. Before asking any question to the Board on this issue the staff analyse the feedback received on the other elements of the proposed objective-based effectiveness assessment particularly on the requirement to ensure that a hedging relationship must be set in such way that it produces an unbiased result and minimises expected hedge ineffectiveness. This is addressed in paper 1B.

[5] See paragraph 26.