Contact(s) **Martin Friedhoff** mfriedhoff@ifrs.org +44 (0)20 7246 6410

Judith Li

Project **Financial Instruments: Hedge Accounting**

Topic **Hedge accounting: hedges of credit risk using credit derivatives (cover note)**

Introduction

1. At the 28 July 2011 meeting, the Board discussed the feedback from the exposure draft *Hedge Accounting* (the ED) on hedges of credit risk using credit derivatives. The Board noted that the accounting for hedges of credit risk using credit default swaps (CDSs) has been a long standing and prevalent issue in practice for financial institutions despite the fact that IAS 39 *Financial Instruments: Recognition and Measurement* allows applying hedge accounting to risk components of *financial* hedged items. Hence, the Board tentatively decided to address this issue specifically.

2. At the 28 July meeting, the Board discussed three alternatives to hedge accounting:

   (a) elective fair value through profit or loss (FVTPL);

   (b) financial guarantee accounting; and

   (c) time value of options accounting.

3. The Board did not make a decision on those particular alternatives but asked the staff to further explore an approach similar to financial guarantee accounting that reflects the insurance-like nature of credit derivatives for the purposes of managing credit exposures ('insurance approach').

4. The following papers will be discussed at this meeting:

(a) Agenda paper 16A: The insurance approach;

(b) Agenda paper 16B: The deemed credit adjustment approach; and

(c) Agenda paper 16C: Comparison of the alternatives.

2. The questions to the Board are included in paper 16C.

Agenda paper 16A

5. Agenda paper 16A describes the *insurance approach* and sets out the staff analysis of this approach. The purpose of that paper is to further explore an insurance approach as requested by the Board.

6. The insurance approach involves applying accrual accounting to credit derivatives to reflect the insurance-like nature of credit derivatives for the purposes of managing credit exposures.

Agenda paper 16B

7. Agenda paper 16B describes a new alternative developed by the staff—the *deemed credit adjustment approach* and sets out the staff analysis of that approach.

Agenda paper 16C

8. Agenda paper 16C sets out a *comparison* of the following three alternatives to hedge accounting:

(a) elective FVTPL (which was set out in the basis for conclusions of the ED and discussed at previous IASB meetings);

(b) the insurance approach; and

(c) the deemed credit adjustment approach.

9. That paper also contains a clarification of the accounting for the measurement change adjustment (MCA) under elective FVTPL.

10. Agenda paper 16C also contains a summary and the questions to the Board.