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Project **Financial Instruments: Hedge Accounting**

Topic **Hedge accounting: hedges of credit risk using credit derivatives—comparison of the alternatives**

Introduction

1. This paper sets out a comparison of the three approaches discussed in this series of papers and previous Board meetings as alternatives to hedge accounting of credit risk.

2. This paper outlines the advantages and disadvantages of the possible alternatives to hedge accounting:

   (a) **elective fair value through profit or loss (FVTPL) accounting** for loans[1] and loan commitments (alternatives 2 and 3)[2];

   (b) '**insurance approach**' (alternatives 1A-B for when a CDS *starts* to qualify for the insurance approach and alternatives 2A-C for when a CDS *ceases* to qualify for the insurance approach and that accounting is discontinued); and

   (c) the '**deemed credit adjustment approach**' (using an aligned CDS with alternatives 1 and 2 or a credit spread curve).

[1] In this paper references to 'loan' are used in a wider sense so as to include financial instruments such as bonds.
[2] Alternative 1 is not included in this paper because based on the feedback received on the ED it would not resolve the issue arising when hedging credit risk using CDSs and hence did not have support.

3. The paper contains two questions to the Board:

   (a) Question 1—which approach does the Board prefer for hedges of credit risk using credit derivatives?

   (b) Question 2—which alternatives under the Board's preferred approach does the Board wish to adopt?

Elective FVTPL

4. Elective FVTPL was discussed in the deliberations leading up to the exposure draft *Hedge Accounting* (ED) as well during the redeliberations of the ED at the 28 July 2011 meeting.[3] At that meeting, the Board requested information about the interaction between impairment accounting and the approach set out in the basis for conclusions (BC) of the ED given that alternative 3 of elective FVTPL accounting includes the 'measurement change adjustment' (MCA).

Interaction with impairment

Alternative 3 of FVTPL

5. The MCA under alternative 3 of elective FVTPL would be amortised over the life of the instrument for loans and loan commitments[4]. To ensure that the MCA is not inappropriately deferred but recognised immediately in profit or loss when impaired, the MCA is subject to an impairment test that is consistent with the amortised cost measurement of the loan. The MCA plus fair value of the loan is tested against the carrying amount after impairment that would be recorded had

[3] Hence, this paper does not include a complete discussion of that approach. For more detailed information on that approach please refer to agenda papers 21-21B of the October 2010 IASB meeting, BC219-BC246 of the basis for conclusions of the ED and agenda paper 5 of the 28 July IASB meeting.
[4] The BC discussed a different accounting treatment for loan commitments. However, the feedback from comment letters and outreach activities was that the different accounting treatments for loans and loan commitments create operational complexity. Hence, the staff suggested that the Board aligns the accounting for MCA for loans and loan commitments (see paragraphs 57 and 58 of agenda paper 5 of the 28 July 2011 meeting).

the loan been continued to be measured at amortised cost. This was phrased in the BC of the ED as follows:

> when the measurement change adjustment plus the fair value is greater than the carrying amount if the loan had been continued to be measured at amortised cost, the amount above amortised cost is recognised as an impairment (to the extent of the unamortised measurement change adjustment)

6. This mechanism was intended to apply if there is an impairment recognised under the impairment model that applies to the credit exposure[5]. This means that alternative 3 of elective FVTPL has interaction with the impairment model for amortised cost[6] as follows:

   (a) For the *timing* of recognising an impairment loss alternative 3 uses the same timing as the impairment model. This means alternative 3 works better in conjunction with a trigger-based or migration model, which provide reference points for impairing the MCA.

   (b) The *measurement* of the impairment loss is the difference arising from comparing the total carrying amount under alternative 3 (ie fair value of the loan plus the remaining unamortised MCA) with the amortised cost that otherwise (ie without applying alternative 3) would have resulted. The amortised cost carrying amount is currently defined to be net of impairment. Hence, indirectly the impairment model influences the measurement of the impairment as well as it is part of the amortised cost to which the carrying amount under elective FVTPL is compared.

7. In summary, the approach for the MCA impairment can be described as a type of 'first loss' approach because any impairment would immediately be applied against the MCA until its amount is reduced to zero. In conjunction with an impairment model that involves a day one loss the MCA would be at a high risk

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[5] In this paper references to 'credit exposure' mean an instrument that gives rise to credit risk (such as a loan, bond or loan commitment from the perspective of the lender or potential lender) and is managed for credit risk by using CDSs (ie the entity is the holder of those CDSs).

[6] For loan commitments the recognition of a provision occurs in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (ie when the 'probable' threshold is met).

of an impairment when the credit quality improves shortly after electing FVTPL accounting unless a different reference point for impairing the MCA was chosen (eg moving out of 'bucket 1' under the current discussion of the impairment model). The likelihood of the MCA being affected by impairment is also driven by the following factors:

(a) how far the fair value of the credit exposure has already declined at the time of electing FVTPL accounting (in broad terms, the deeper the less likely an impairment of the MCA becomes);

(b) the amortisation of the MCA, which over time reduces the remaining amount at risk for an MCA impairment.

Alternative 2 of FVTPL

8. Conversely, alternative 2 of elective FVTPL accounting is completely de-linked from the impairment model. Hence, alternative 2 does *not* depend on what impairment model is applied and therefore is compatible with any impairment model that results from phase 2 of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. Also, because the credit exposure is measured at FVTPL, this approach does not need a qualifying criterion that the maturity of the CDS must be equal to or longer than that of the credit exposure (which, in contrast, is a consideration under the insurance approach and the deemed credit risk adjustment approach).

Active and flexible risk management

9. In order to facilitate the comparison with the other approaches, this section briefly summarises the aspect of discontinuing elective FVTPL accounting.

Alternative 3 of FVTPL

10. Any unamortised MCA at the date of discontinuation is added to the fair value of the financial instrument as its new deemed cost. Hence, the MCA is recognised over time or immediately released to profit or loss (eg when impaired or the

underlying exposure is derecognised) in a way that is consistent with amortised cost measurement.

11. For loan commitments the approach as described in the BC of the ED would revert to the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* after the discontinuation of elective FVTPL.

12. However, because of the suggested modification of the elective FVTPL that would use an amortisation approach for the MCA also for loan commitments[7], the staff think that the Board should consider also aligning the accounting on discontinuation for loan commitments with that for loans (ie use amortisation instead of reverting to IAS 37). There is also another rationale for using an amortisation approach:

    (a) it prevents an immediate gain from derecognising the loan commitment under IAS 37 if the probable threshold is not met when discontinuing elective FVTPL, which reduces concerns for earnings management; and

    (b) the reasons discussed in the context of discontinuing the deemed credit adjustment (see paragraph 31(b)(ii) of paper 16B) because much of the fair value change of loan commitments is driven by credit risk.

13. The (other) advantages and disadvantages of alternative 3 of elective FVTPL are discussed in agenda paper 5 of the 28 July 2011 meeting and in the BC of the ED.

Alternative 2 of FVTPL

14. The difference between alternatives 2 and 3 of elective FVTPL is the accounting for the MCA. Under alternative 2 of elective FVTPL, the MCA is recognised immediately in profit or loss. Hence, on discontinuation of FVTPL accounting there is no MCA that needed to be accounted for.

15. For loans the fair value at the time of discontinuing elective FVTPL becomes its new deemed cost.

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[7] See paragraph 5 and Footnote 4.

16. For loan commitments the approach as described in the BC of the ED would revert to the requirements of IAS 37 after the discontinuation of elective FVTPL.

17. However, even though alternative 2 does not involve an MCA, the staff think that the Board should consider aligning the accounting for loan commitments on discontinuation with that for loans (ie use amortisation instead of reverting to IAS 37) for similar reasons as contemplated for alternative 3 (see paragraph 12).

18. The (other) advantages and disadvantages of alternative 2 of elective FVTPL are outlined in paragraphs BC236 to BC238 of the BC.

The insurance approach

Advantages of the 'insurance approach'

19. The insurance approach is a simple and straightforward solution *if the CDS is acquired and used as credit protection for one particular credit exposure with a matching (remaining) maturity*. *In that simple situation* the advantage of the insurance approach over the elective FVTPL and the deemed credit adjustment approach is operational simplicity, which benefits from the straightforward application of accrual accounting to the credit derivative.

20. The insurance approach has a simple interaction with the impairment model because of the treatment like collateral or a guarantee, which means it affects the estimate of the recoverable cash flows in the same way. Hence, this interaction is at the most basic level of the information that any impairment model uses. This assumes that *only* credit derivatives with a remaining life *equal to or longer* than the remaining exposure period would qualify for the insurance approach.

21. In addition, the insurance approach does not need to switch the measurement of the loans and loan commitments to fair value. Since the measurement of the loans and loan commitments would remain at amortised cost or are unrecognised, respectively, the insurance approach eliminates the need to provide an accounting treatment for discontinuing this approach *for the credit exposure*.

22. The staff also note that the insurance approach is also most closely aligned with the risk management view (see paragraphs 8 and 9 of the agenda paper 16A) and

is the approach most preferred by credit risk managers. Hence, arguably, this approach best achieves the objective of hedge accounting to reflect the risk management activities of entities.

Disadvantages of the 'insurance approach'

23. One of the significant disadvantages of the approach is that the credit derivative is not recognised at fair value on the balance sheet. The staff note that fair value provides important and relevant information about derivative financial instruments. The staff consider that this could be mitigated by disclosing the fair value in the notes to provide transparency.

24. Another disadvantage of the insurance approach is that neither the credit derivative nor the loan or loan commitments are recognised at fair value. Hence, any mismatch of economic gains or losses (ie economic hedge ineffectiveness) between the loan or loan commitment versus the credit derivative would not be recognised in profit or loss. While situations in which the *maturity* of the CDS exceeds that of the credit exposure can be addressed by using an aligned CDS, that would not capture differences between the actual CDS and the exposure that do not relate to CDSs because the insurance approach only intends to change the accounting for the CDS but not to adjust the credit exposure for value changes that reflect all its characteristics. Also, if used, aligned CDSs increase the operational complexity.

25. Another disadvantage of this approach is that difficulties arise when the insurance approach is discontinued before maturity of the credit exposure—then the consequences of using accrual accounting for the CDS become obvious, ie the problem of having to revert to measurement at fair value. Each of the three alternatives for that situation has its drawbacks. In essence, the alternatives are different positions in a trade-off between preventing earnings management, complexity and conceptual weaknesses.

The deemed credit adjustment approach

Advantages of the deemed credit adjustment approach

26. The deemed credit adjustment approach retains the measurement of CDSs at fair value through profit or loss. This means the accounting for the CDS is not affected by any switches between periods for which the credit derivative is and is not used to manage a particular credit exposure (in contrast to the insurance approach).

27. When the deemed credit adjustment approach is discontinued before maturity of the credit exposure accounting similar to that for discontinued fair value hedges can be used for loans and bonds. (For loan commitments the Board would have to decide whether to use an amortisation approach or leave the deemed credit adjustment unchanged until it is derecognised.)

28. Since only the deemed credit risk is accounted for under this approach, it would not create profit or loss volatility from changes in market interest rates (in contrast to elective FVTPL).

Disadvantages of the deemed credit adjustment approach

29. Using aligned CDSs involves some complexity in their construction and does not allow all relevant characteristics of the credit exposure to be captured. Alternatively, an approach using a credit spread curve would be operationally even more difficult, require estimates of aspects such as draw down and prepayment behaviour and require a liquid CDS market for a given ‘name’ (particular credit exposure).

30. The interaction with impairment accounting is significantly more complex than under the insurance approach or elective FVTPL (in particular alternative 2) because the deemed credit adjustment and the impairment allowance are ‘competing mechanisms’ in accounting for impairment losses. The interaction depends on the type of impairment model and would be more difficult in conjunction with an expected loss model.

Conclusion and questions to the Board

31. The Board noted at the 28 July 2011 meeting 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. The current accounting under IFRSs creates artificial profit or loss volatility due to the accounting mismatch of gains and losses of the loans and loan commitments (measured at amortised cost and generally unrecognised, respectively) versus the credit derivatives (measured at fair value through profit or loss).

32. In the deliberations to the ED the Board considered addressing the accounting mismatch by measuring the loans and loan commitments at fair value through profit or loss. At the 28 July 2011 meeting, the Board redeliberated this approach, but thought that the accounting mismatch might potentially instead be addressed by applying accrual accounting to the credit derivatives.

33. The staff consider that the key criteria for deciding on which approach to adopt are:

    (a) The relevance of the information;

    (b) The interaction with the impairment model;

    (c) Operational aspects and complexity.

34. The staff considerations are set out in the following sections.

Relevance of information

35. The status quo under IAS 39 in which CDSs are accounted for as at FVTPL while credit exposures are at amortised cost or unrecognised clearly is highly deficient. It results in recognising gains on CDSs while the impairment is recognised on a different measurement basis and with a time lag because of the impairment models. Hence, in a situation in which the situation of a lender deteriorates but it has protected itself gains are being shown even though the protection keeps the situation at best rather 'neutral'.

36. Among the alternatives discussed in this paper series:

(a) Elective FVTPL uses fair value for both the CDS and the credit exposure (with the MCA overlay for alternative 3). This best captures all economic mismatches but comes at the expense of inevitably including a remeasurement for interest rate risk as well. This alternative has the *clearest objective* of all the approaches (fair value measurement). As a result, if alternative 2 of the elective FVTPL is chosen, it would require the least guidance (alternative 3 of the elective FVTPL would require some more in view of the MCA). Under alternative 2 of the elective FVTPL there can be concerns about earnings management because on electing FVTPL the difference to the previous carrying amount of the credit exposure is immediately recognised in profit or loss—however, some consider that as relevant as it signals a different approach to managing credit risk and this difference would often be a loss reflecting the lag of the impairment model behind the market view, which (to be consequent) should be 'accelerated' when switching to a fair value based credit risk management.

(b) The insurance approach would provide some 'intuitive' results in the simple situation in which the CDS is acquired and used as credit protection for one particular credit exposure with a matching (remaining) maturity. This approach addresses concerns about volatility (as described in paragraph 35) but fair value information on CDSs would only be available in the notes. In contrast to elective FVTPL, the relationship between the effect of credit risk on the CDS and on the credit exposure would occur 'in the shadow' using a combination of accrual accounting and collateral accounting—neither of which is transparent on the face of the primary financial statements regarding credit driven fair value changes as those compensate each other off balance sheet. In the case that a CDS based strategy does not have the intended effect (eg a credit deterioration is not captured by CDS credit event clauses such as a 'soft restructuring') this would not be as transparent as under the elective FVTPL approach. Moreover, the

consequences of using accrual accounting for the CDS become obvious when discontinuing the insurance approach accounting, ie the problem of having to revert to measurement at fair value, for which there is no satisfactory answer.

(c) The deemed credit adjustment approach uses a remeasurement of credit risk on a 'deemed' basis (ie built from using the CDS as the proxy for credit risk). This results in full fair value for the CDS but the credit exposure is only remeasured on a deemed basis. Hence, any distortions in CDS markets would spill over into that measure of credit risk. Also, the 'adjusted' measurement combines measurements in a manner similar to fair value hedge accounting today but is more confusing than that type of measurement because the part being remeasured is only occurring on a 'proxy' basis. The advantage is that interest rate risk related changes in fair value can be screened out.

The interaction with the impairment model;

37. Among the alternatives discussed in this paper series:

(a) Elective FVTPL under alternative 2 is completely de-linked from the impairment model and has the least interaction of all approaches and alternatives with impairment. Alternative 3 of the elective FVTPL has interaction with the impairment model because of the MCA and could best be combined with a trigger-based or migration model, which provide reference points for impairing the MCA (otherwise the interaction becomes difficult).

(b) The insurance approach has a simple interaction with the impairment model because of the treatment like collateral or a guarantee. This makes it compatible with all impairment models.

(c) The deemed credit adjustment approach has interaction with impairment accounting that is significantly more complex than under the insurance approach or elective FVTPL because the deemed credit adjustment and the impairment allowance are 'competing mechanisms'

in accounting for impairment losses. The interaction depends on the type of impairment model and would be more difficult in conjunction with an expected loss model. Hence, this approach has ramifications regarding phase 2 of the project to replace IAS 39.

Operational aspects and complexity.

38. Among the alternatives discussed in this paper series:

    (a) Elective FVTPL under alternative 2 is operationally the least complex. Alternative 3 is more complex because of the MCA that needs to be accounted for, which requires an amortised calculation to be run for loans in the background.

    (b) The insurance approach has a low complexity in the simple situation in which the CDS is acquired and used as credit protection for one particular credit exposure with a matching (remaining) maturity. In other situations the need to use aligned CDSs increases complexity.

    (c) The deemed credit adjustment approach involves complexity because of using aligned CDSs or alternatively an approach using a credit spread curve, which is arguably operationally even more difficult, and would require estimates of aspects such as draw down and prepayment behaviour.

Staff consideration of how to proceed

39. As the staff have noted at the 28 July 2011 meeting, there is no satisfactory solution: all approaches have their drawbacks. The Board should consider an approach that best addresses the issue in light of the pros and cons that each approach (and the related alternatives) presents. This will be driven by what aspects (see paragraph 33) are considered most important as there are trade-offs for each approach between those aspects.

40. The staff consider that the Board has two broad alternatives given phase 2 of the project to replace IAS 39 is still ongoing:

(a) either choose an approach that has little interaction with impairment and hence would be compatible with whatever model is finally developed for the impairment of financial instruments; or

(b) consider the accounting for hedging credit risk with CDSs once the new impairment model is known, which would allow an approach to be chosen that has a more intense interaction with impairment. Given that none of the approaches being considered are actually part of hedge accounting (ie they are all *alternatives to* hedge accounting) that approach is a viable one.

41. In the staff's view that narrow the choice for a solution as part of the hedge accounting phase down to:

(a) alternative 2 of elective FVTPL (even though alternative 3 might be considered given the interaction only relates to the MCA assuming that would not be large as buying CDSs that are deep in the money is typically not viable as a commercial credit risk management strategy); and

(b) the insurance approach.

42. Given the significant problems involved in discontinuing the insurance approach accounting (see alternatives 2A-C in paper 16A) the staff consider the Board should choose between alternatives 2 and 3 of elective FVTPL.

43. The staff recommend that if the Board chooses alternative 2 or 3 of elective FVTPL it should use amortisation to discontinue elective FVTPL (also) for *loan commitments* (see paragraphs 12 and 17).

44. The disclosures that could accompany alternative 3 of elective FVTPL have been set out in the BC of the ED. Those were:

> BC244 The Board noted that disclosures could provide transparency on the measurement change adjustment. The Board considered a reconciliation of changes in the measurement change adjustment balance during the period that would include, for example, the following reconciling items:
>
> (a) additions as a result of electing fair value through profit or loss accounting;

(b) releases:

(i) amortisation

(ii) impairment

(iii) discontinuation

(iv) transfers to allowance account for credit losses; and

(c) the effect of foreign exchange rate changes.

BC245 The Board also considered a reconciliation of the nominal amount and the fair value of the credit derivatives that have been used to manage the credit exposure of a financial instrument that qualified and was elected for fair value through profit or loss accounting.

45. When choosing alternative 2 of elective FVTPL an MCA is not applicable. Hence, the staff recommend requiring disclosure of:

(a) a reconciliation of the nominal amount and the fair value of the credit derivatives that have been used to manage the credit exposure of a financial instrument that qualified and was elected for fair value through profit or loss accounting;

(b) the gain or loss recognised in profit or loss as a result of electing FVTPL accounting for a credit exposure; and

(c) for discontinuations of elective FVTPL for credit exposures the fair value that becomes new deemed cost or amortisable amount (for loan commitments) and the related nominal or principal amount.

46. If the Board cannot agree on one of the two alternatives for elective FVTPL accounting the staff recommend that the Board consider the accounting for hedging credit risk with CDSs once the new impairment model is known, which would allow choosing an approach that has a more intense interaction with impairment. *However*, the staff reiterate that finding a solution for hedging credit risk using CDSs has been an as good as unanimously supported request to the Board and that the current situation of debt and credit markets requires a timely solution for this issue.

Question 1
Which *approach* does the Board prefer for hedges of credit risk using credit derivatives, and why?

Question 2
Which *alternatives* under the Board's preferred approach does the Board wish to adopt, and why?