STAFF PAPER

22 – 26 April 2013

IASB Meeting

Project	**Hedge Accounting (IFRS 9)**
Paper topic	Scope and interaction with macro hedging activities

CONTACT(S) Martin Friedhoff mfriedhoff@ifrs.org

Introduction

1. At its January meeting, the Board discussed an issue that was raised by a number of banks commenting on the draft hedge accounting requirements for IFRS 9 *Financial Instruments*[1]—the scope of the new hedge accounting model and how that model interacts with designations of hedging relationships in the context of macro hedging activities.

2. At that meeting the Board requested that the staff provide an analysis of how a scope out of 'macro cash flow hedges' from the new hedge accounting model might be achieved, any reasons why it might be necessary, and the consequences that such a scope out might have.

3. This paper:

   (a) provides an analysis of the issue including why a scope-out may or may not be needed; and

   (b) asks the Board whether it wants to change the draft hedge accounting requirements and if so how.

[1] See draft of the forthcoming hedge accounting requirements posted on the IASB website on 7 September 2012 (http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognitio/Phase-III-Hedge-accounting/Pages/Draft-of-IFRS-General-Hedge-Accounting.aspx).

Feedback received

4. Staff paper 4B of the January 2013 IASB meeting summarised the scope and the macro hedging related feedback that was received on the draft hedge accounting requirements. That feedback was as follows:

   (a) Some commentators advocated that, pending the completion of the project on accounting for macro hedging, 'macro cash flow hedge accounting'[2] should be *grandfathered*.

   (b) Some commentators were concerned about perceived conflicts of the existing practice of 'macro cash flow hedge accounting' with the new hedge accounting model.

   (c) For some commentators it was unclear whether, when using the scope exception for 'macro fair value hedge accounting', all of the hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement* apply or only the specific paragraphs of IAS 39 that are cited in paragraph 6.1.3 of the draft.

5. The Board addressed that feedback at its January 2013 meeting. In response to the matters set out above the Board agreed to clarify that designations do not have to be the same as the risk management view but need to be directionally consistent with it and that an explicit explanation be provided that by not carrying forward relevant Implementation Guidance the Board was not rejecting it.

6. However, the Board did not make a decision on whether to provide a scope out for 'macro cash flow hedges' from the new hedge accounting model pending additional feedback from the European Financial Reporting

[2] **Usage note**: this term is colloquially used to refer to the accounting illustrated in the Implementation Guidance that accompanies IAS 39 (IGs F6.1-F.6.3) regarding the interest rate risk management in financial institutions when that risk is managed on a net basis. Solely for ease of reference, this paper uses that colloquial term even though IAS 39 does *not provide a special accounting treatment* for macro cash flow hedging. This accounting is allowed *as a way of applying the general hedge accounting model of IAS 39* in the circumstances of an entity that manages interest rate risk on a net basis including in the context of open portfolios. In that sense it is simply an application of *a cash flow hedge* under the general hedge accounting model. It is not a 'macro cash flow hedge accounting' treatment—cash flow hedges can be applied in different circumstances, including when (economic) macro hedging activity is undertaken and the respective designations reflect the relevant circumstances.

Advisory Group (EFRAG) and the analysis[3] that the Board requested from the staff.

7. EFRAG sent a second letter to the IASB on 22 March 2013[4]. That letter solely deals with the impact of the new hedge accounting model on 'macro hedge accounting'. EFRAG's view is that the IASB should allow entities to maintain the status quo of 'macro hedge accounting' in order to:

   (a) *provide certainty* that IAS 39-compliant practices of designating hedging relationships for portfolio hedging remain available (until the project on accounting for macro hedging is completed); and

   (b) avoid *costs of assessing* whether those practices are IFRS 9 compliant *and the risk of entities having to change those practices twice* (ie as a consequence of adopting IFRS 9 and, later on, the requirements resulting from the project on accounting for macro hedging).

8. The letter states that in EFRAG's view, the most straightforward and practical way of achieving this would be to allow entities an accounting policy choice between:

   (a) continuing to apply the hedge accounting requirements of IAS 39 instead of the new hedge accounting model (ie for *all* hedging relationships) until the earlier of:

      (i) the entity irreversibly deciding to adopt IFRS 9 (also) for hedge accounting; and

      (ii) completion of the Board's project on accounting for macro hedging; **or**

   (b) the entity irreversibly adopting IFRS 9 for hedge accounting[5].

[3] See paragraph 2.

[4] See Appendix A.

[5] That would include the scope out for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities (see paragraph 6.1.3 of the draft hedge accounting requirements).

Staff analysis

Maintaining the status quo of 'macro hedge accounting'—broadly

9. The draft requirements (as posted on the IASB's website) *broadly* maintain the status quo of hedge accounting in macro hedging situations. This was explained in the past in several documents:

   (a) The Exposure Draft *Hedge Accounting* published in December 2010 (ED).[6]

   (b) Staff paper 4 of the May 2012 IASB meeting.[7]

   (c) The draft hedge accounting requirements that were made available in early September 2012.[8]

10. All those documents explained that an entity could choose to continue to apply the specific 'macro hedge accounting' requirements in IAS 39—ie for the fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities. In contrast, cash flow hedges, which are the subject of the 'general' (ie non-macro) hedge accounting requirements in IAS 39 today would be in the scope of the new (general) hedge accounting model.

11. As analysed in the January 2013 staff paper 4B, the staff are of the view that in circumstances in which entities have IAS 39 compliant hedging relationships using the current cash flow hedge requirements such hedging relationships should achieve hedge accounting under the requirements as set out in the review draft—particularly given the clarifications agreed by the Board at the January 2013 meeting. Subsequent outreach confirmed that those clarifications were well received and help to mitigate unease about application of the draft hedge accounting requirements.

12. Because cash flow hedge accounting can also be applied under the new hedge accounting model in situations in which economically macro hedging

[6] See paragraph 3 of that ED.

[7] See paragraph 14 of that paper.

[8] See paragraph 6.1.3 of the draft hedge accounting requirements.

activity is being undertaken, this *broadly* maintains the status quo for that type of hedge, ie in the sense that hedge accounting can be achieved in those situations. The primary reason is that the relevant requirements for designating risks from financial items as the hedged item are not changed.

13. So in summary the draft hedge accounting requirements would result in the status quo for 'macro hedge accounting' being *broadly* maintained as the combined result of two different aspects:

    (a) the scope out for the fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities; and

    (b) the ongoing ability to apply cash flow hedge accounting in 'macro' situations under the IFRS 9 hedge accounting model.

14. In terms of the interaction with the broader project on accounting for macro hedging, the intention has been that ultimately the scope-out for the fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities would be *temporary*. Ultimately this scope-out would end when a new model for macro hedging is put in place.

The basis for a grandfathering request

15. In addition to the feedback received from EFRAG as outlined above, following the January 2013 IASB meeting the staff has undertaken targeted outreach with stakeholders to better understand the basis for concerns about the scope of the IFRS 9 hedge accounting requirements and the interaction with IAS 39.

16. In this process we were not provided with any specific examples of instances when entities would be unable to apply hedge accounting as a result of the proposed 'migration' of cash flow hedge accounting for macro hedging activities to IFRS 9. In particular, we enquired whether issues arose as a result of the interaction with the EU carve-out and no examples were provided.

17. However, it appears to be the case that there is still a general unease that IAS 39 compliant hedging relationships will not qualify for hedge accounting under IFRS 9.

18. The other concern raised is one of perceived burden. This is being raised because we are in the relatively unusual position of having an open project (accounting for macro hedging) that overlaps in scope with the impending changes to hedge accounting for IFRS 9. This calls into question whether it is appropriate to require entities to 'change their accounting twice'—moving first to IFRS 9 and then potentially to a new accounting regime for macro hedging. The staff set out below the practical considerations of moving to IFRS 9 to enable the Board to assess the extent of this burden.

Applying IAS 39 versus the draft requirements: what is the difference in effect?

Designation of the hedged item

19. The most important aspect of applying hedge accounting in the context of macro hedging activities is the designation of the hedged item because it affects:

(a) whether hedge accounting can be achieved at all (ie whether there is an eligible hedged item); and

(b) how hedging relationships are set up in IT-systems, which relates to the cost and effort that might result from changes to how the hedged item is designated.

20. IAS 39 already allowed designations on a risk component basis for *financial* hedged items. The new hedge accounting model does not change this. It has not changed the criteria for eligibility of risk components (ie that they are separately identifiable and reliably measurable)[9]. This relates to the designation of benchmark interest rate and partial term risk components that are used for 'macro cash flow hedge' designations.

[9] The new model has *extended* that notion to *non-financial* hedged items.

21. Also, the ability under IAS 39 to designate risks arising from highly probable forecast transactions also exists under the new hedge accounting model. This relates to including cash flows related to reinvestments in the designation of the hedged item, which is typical of 'macro cash flow hedge' designations.

22. Under both IAS 39 as well as the new hedge accounting model, cash flow hedges of interest rate risk cannot be designated on a net position basis but entities must instead designate gross positions. Staff paper 4B of the January 2013 IASB meeting explained that this requires a kind of so called 'proxy hedging' because the designation for hedge accounting purposes is on a gross position basis even though actual risk management typically manages on a net position basis. This includes approaches that determine the net interest rate risk position on the basis of fixed rate items. Those are *directionally* consistent with a cash flow hedge designation in that the net interest rate risk position has a dual character: the hedges bridge, for example, the economic mismatch between fixed rate assets and variable rate funding (existing variable rate funding as well as funding to be obtained in the future to continue to fund the assets as existing funding matures). This mismatch can be regarded as fair value interest rate risk when looking at the assets and as cash flow interest rate risk when looking at the funding. The net position hedging combines both aspects and stabilises the net interest margin. Hence, both fair value and cash flow interest rate risk are inherent aspects of the hedged exposure. Hedge accounting requires to use designation of the hedging relationship as either a fair value hedge or as a cash flow hedge. In that sense, even if a fair value hedge designation better represented a risk management perspective that considers the fixed rate assets as the primary or leading aspect, a cash flow hedge designation would still be directionally consistent because of the dual character of the of the risk position. Consequently, 'proxy hedging' is an eligible way of designating the hedged item as long as that is at least directionally consistent with risk management, which is the case in this situation. Staff paper 4B of the January 2013 IASB meeting also explained this notion and the Board agreed with that analysis.

23. Therefore, entities *that use IFRSs* can still designate the hedged item for cash flow hedges of interest rate risk using benchmark interest rate and partial term risk components and include cash flows related to reinvestments. Consequently, regarding the designation of the hedged item, there are no significant systems implications that would result.

24. The situation would be different for entities that use the *modified version of IAS 39 endorsed in the European Union* (EU) and *for cash flow hedges* choose accounting policies that are only available because of the carve-out[10] but that do not comply with IFRSs. Those entities could no longer use the EU carve-out when adopting IFRS 9. In our outreach, despite specifically asking the question, we have not identified entities that raised this as a concern or as a basis for grandfathering.

Hedge effectiveness assessment

25. The hedge effectiveness assessment under the new hedge accounting model has widely been considered a significant improvement over the percentage 'bright range' test of 80-125 per cent currently in IAS 39, both in terms of:

    (a) avoiding arbitrary outcomes of the assessment; and

    (b) providing operational relief.

26. This feedback was also shared by the banks among the respondents to the ED as well as in the accompanying outreach.

27. Consequently, the change to the new hedge effectiveness assessment is a *relief* from onerous operational requirements that cannot be reasonably characterised as having significant (detrimental) systems implications. Instead, it would mitigate some of the practice issues that are associated with applying 'macro cash flow hedge accounting' under IAS 39, such as the effect on the hedge effectiveness assessment resulting from credit risk related fair value changes and aggregating cash flows in time bands.

[10] The carve-out refers to the parts of IAS 39 that were omitted from the version of IAS 39 that was endorsed in the EU.

28. Therefore, the change of the hedge effectiveness assessment requirements does not support the call for a continued application of IAS 39 to 'macro cash flow hedge accounting'.

Documentation

29. IAS 39 as well as the new hedge accounting model include documentation requirements as part of the qualifying criteria for hedge accounting. The difference between those requirements relates to the documentation of the hedge effectiveness assessment. That is a consequence of the different effectiveness assessments under IAS 39 and the new hedge accounting model.

30. Hence, entities need to update the documentation of hedging relationships to reflect that new assessment. Given that hedge accounting was applied under IAS 39 before, the entity knows the sources of hedge ineffectiveness. The entity also knows how it determines the hedge ratio, which is often 1:1 for such interest rate hedges anyway.

31. The staff are of the view that the documentation can be updated in a manner that is not burdensome. It can be updated using a master document approach whereby the part of the documentation that is the same for similar hedges (eg risk management strategy, sources of hedge ineffectiveness or how the hedge ratio is determined) can be in one central document that is then included by cross reference in the documentation of specific hedging relationships that includes the identification of the specific hedging instruments and hedged items.

32. So the change in documentation is about updating a master document for information readily available to the entity. Consequently, this documentation change cannot be reasonably characterised as having significant systems implications.

Summary

33. If the new model made changes to how the hedged item can be designated and hence how it is embedded in IT-systems that would create potentially significant system changes. But the new hedge accounting model does not

necessitate such changes for the types of hedging relationships giving rise to grandfathering requests.

34. As outlined above, the main change is to hedge effectiveness requirements, which have been *simplified*, and to documentation, which is capable of being streamlined. In the staff's view a migration to IFRS 9 should not result in significant systems changes for 'macro cash flow hedges'.

Conclusion

35. As analysed above, the staff are of the view that the systems implications of actually changing cash flow hedge accounting for the macro hedging activities that are being raised are not in fact significant.

36. As analysed in staff paper 4B of the January 2013 IASB meeting, the staff are of the view that IAS 39 compliant hedges should qualify for hedge accounting under IFRS 9. Concerns were raised in response to the draft hedge accounting requirements about whether so-called 'proxy hedging' would be possible under IFRS 9. This was discussed by the Board at the January 2013 meeting. We have received feedback that the clarifications that the Board agreed at the January 2013 meeting should address most concerns. The staff continues to believe that these concerns are best (and adequately) addressed using the clarifications previously agreed by the Board.[11]

37. As with any change in requirements, implementation questions will undoubtedly be raised as the changes are newly applied and there will be a 'settling in' period. It is probably fair to say that the complexity of hedge accounting (whatever the model) is adding to concerns. However, the staff have not identified any additional issues that need to be addressed and are of the view that a general unease is not in itself the basis for deferring the application of new requirements.

38. What remain as concerns could only potentially be explained by:

[11] The staff are also concerned that if grandfathering were provided on the basis of a general concern that 'proxy hedging' no longer allowed achieving hedge accounting, it would in fact undermine the application of IFRS 9, ie it would be contrary to the changes agreed by the Board in January 2013 that seek to confirm that for 'proxy hedging' that is directionally consistent with risk management hedge accounting is in fact achievable.

(a) **The costs of adopting the new hedge accounting model**, ie the:

   (i) costs of assessing whether 'macro cash flow hedge accounting' practices comply with the new hedge accounting model; and

   (ii) the costs of changing those practices twice.

   The staff consider that the effort of assessing whether 'macro cash flow hedge accounting' practices comply with the new hedge accounting model should not be overly burdensome for those practices that complied with IAS 39. The analysis in this paper, the staff paper 4B of the January 2013 IASB meeting and the clarifications agreed by the Board should provide support for this process.

(b) **New disclosure requirements**. Changes to IFRS 7 *Financial Instruments: Disclosures* are planned in addition to the new hedge accounting requirements. Some have mentioned these new requirements in their requests for grandfathering. This is actually a separate issue. These disclosures apply *irrespective* of whether an entity uses the requirements of IAS 39 or the new hedge accounting model that will become part of IFRS 9. The Board included special requirements for disclosures in the context of 'dynamic' risk management processes that balance operational burden with the information needs reflected in the disclosure objectives.

   Those new disclosures are in response to the deficiencies of existing hedge accounting disclosures and therefore, from the outset of the project, have been proposed to apply even for those hedging relationships that can continue to be designated under IAS 39 (ie even for the fair value hedges of interest rate exposure of a portfolio of financial assets or financial liabilities that the Board has already proposed to grandfather). Therefore, any relief from the new disclosure requirements would actually be an *additional exemption* above and beyond the grandfathering discussion[12]. The staff do not think that this factor should be considered in making the decision on the scope of the application of the IFRS 9 hedge accounting model.

(c) **Application of 'macro cash flow hedge accounting' that is not IAS 39 compliant**. Our analysis is necessarily of IAS 39 compliant hedges. Clearly if an entity were in fact not compliant with IAS 39 we cannot (and should not) comment on whether their practices would comply with IFRS 9[13].

39. Given the above, in the staff's view, we come back to general unease about cash flow hedge accounting for macro hedging under IFRS 9 being the basis upon which the Board should consider the need for any changes to the scope of IFRS 9 hedge accounting. The considerations above mean that the issue from a standard setting perspective is one of *change management*: how best to address the unease about changing to the new hedge accounting model and whether we need to address the scope of IFRS 9 to manage that change.

Possible ways of achieving continued application of IAS 39 'macro cash flow hedge accounting'

40. In January the Board agreed to clarifications to the draft hedge accounting requirements to assist in the application of IFRS 9 to 'macro cash flow hedging'. This section analyses different approaches the Board could consider to continue application of IAS 39 'macro cash flow hedge accounting' under IFRS 9 to address the outstanding concerns that may remain (as analysed above):

(a) Retaining the 'macro cash flow hedge accounting' related Implementation Guidance that accompanies IAS 39:

(i) carrying forward the Implementation Guidance as material that accompanies but is not part of IFRS 9; or

[12] In the staff's view this would conflict with the Board's objective to improve the transparency of hedge accounting, which is especially important in circumstances like 'proxy hedging'

[13] To do so we would need to understand what they are doing and we do not have those details.

(ii) integrating the Implementation Guidance into IFRS 9 (ie elevate it to become an integral part of the standard).

(b) Providing a scope exception from IFRS 9:

(i) as a *specific* scope exception that aims to only allow continued application of IAS 39 for particular hedges; or

(ii) as a *general* choice between applying IAS 39 instead of IFRS 9 for hedge accounting.

Carrying forward the 'macro cash flow hedge accounting' related Implementation Guidance

41. The staff consider that actually carrying forward the Implementation Guidance as material that accompanies but is not part of IFRS 9 would not achieve its purpose, for the reason set out in staff paper 4B of the January IASB meeting (ie that if there was a conflict between the (non-authoritative) Implementation Guidance and the new (authoritative) hedge accounting model the IFRS requirements would prevail over the Implementation Guidance).

Integrating the 'macro cash flow hedge accounting' related Implementation Guidance into IFRS 9

42. Integrating the Implementation Guidance into IFRS 9 would require editorial changes. The Implementation Guidance uses different terminology than that used in IFRS 9 and is thus incompatible. In addition, references are made to requirements in IAS 39 that have been changed when developing the new hedge accounting model (eg in relation to the effectiveness test or risk components of non-financial items). Inevitably, wording changes, even when editorial in nature would raise concerns about whether substantive changes to the status quo of the Implementation Guidance were intended and risk amplifying the problem that their integration would be intended to resolve.

43. The staff also consider that given the risk of unintended consequences the question of the need for re-exposure could be raised.

Providing a specific scope exception from IFRS 9

44. A scope exception for particular types of hedges could be used to describe the particular hedges to which IAS 39 could continue to apply. This would increase the complexity of IFRS 9 and creates the risk of the scoping not working as intended.

45. Some have suggested a scope exception based on references to 'macro hedging' activities or 'open portfolios'. However, the staff are concerned that this is too imprecise and open-ended given that those terms are not well defined. They can be used to broadly describe what a project is about but are not sufficiently robust to support a scope exception without further development. Such definitions may be explored as part of the Board's project on accounting for macro hedging. However that project has yet to go through the full due process and at this stage we do not know if such a reference will even be needed as part of that project. Therefore, including a scope exception on that basis without further due process and development of more detailed explanations or application guidance is not feasible and success is uncertain.

46. To more clearly define a scope exception the Board could consider limiting it to hedges with the following characteristics:

    (a) hedges of interest rate risk;

    (b) risk arising from and managed on the basis of net positions; and/or

    (c) risk arising from open portfolios that is managed dynamically.

47. Limiting the hedges that would qualify for the scope exception to hedges of **interest rate risk** would restrict the exception to one type of risk. This has the benefit that the type of risk can be clearly described such that this criterion would be operational.

48. However, limiting the scope exception has its drawbacks:

    (a) It raises the question of being arbitrary in that entities that for example hedge foreign exchange (FX) risk might also argue they have their systems and processes in place and also do not want to change now and potentially twice, eg regarding documentation.[14]

(b) Further guidance might have to be provided for more difficult situations that would result from this scope exception. For example, if different types of risks are hedged with one hedging instrument (eg interest rate risk and FX risk) this would result in one financial instrument being a hedging instrument under two different hedge accounting models (with different effectiveness assessment and hedge accounting discontinuation requirements) at the same time. Providing such guidance would take time to develop and increase the complexity of the requirements. Not providing such guidance would leave open questions and create the risk of issues being raised with the Interpretations Committee and could result in the call for annual improvements or limited scope projects.

49. Limiting the hedges that would qualify for the scope exception to hedges of interest rate risk that arises from a **net position** would align the exception more closely to the fact patterns being raised. A gross position could be any single loan or other item giving rise to interest rate risk so allowing gross positions would in effect be the same as only limiting eligibility by type of risk. But even when limiting the scope exception to hedges of net positions, there can still be some situations that—at least technically—could be considered net positions even though they are not the situation to which 'macro cash flow hedge accounting' is applied today but that are more akin to interest rate risk exposures from single items, for example:

(a) a loan or bond for which repayment is achieved through payment to a third party (eg a trust), which is also known as "in substance defeasance"[15], which results in the separate presentation of an asset and a liability (ie a net position);

[14] The IASB's project on accounting for macro hedging is not limited to interest rate risk but also addresses other risks such as FX risk so it is not a differentiating factor.

[15] See IFRS 9.B3.3.3.

(b) "sinking fund" arrangements[16] whereby financial assets are set aside for repayment of a liability without having been accepted as settlement of the obligation would have a similar effect;

(c) also, loans with a linked 'offset account' that does not qualify for offsetting under IAS 32 *Financial Instruments: Presentation* would have a similar effect, eg loans for which the basis of charging interest is reduced by the balance of a linked current account;

(d) repo transactions whereby financial assets are sold but do not qualify for derecognition so that the transaction is accounted for as a collateralised borrowing also would technically create net positions for interest rate risk.

50. In those situations interest rate risk would typically be managed on the basis of those net positions. In that sense, a net position would not in itself be a sufficient reference point to prevent IAS 39 being applied to interest rate risk arising in situations that are more akin to interest rate risk exposures from single items. This would mean that the scope exception could be broader than the issue being targeted.

51. Also, more generally, if an entity has financial assets and financial liabilities that give rise to interest rate risk then it has a net position so it would depend on whether those assets and liabilities, at least to some extent, are managed together.

52. An additional way to narrow down the scope exception would be to limit it to hedges of interest rate risk that arises from **open portfolios** that is **managed dynamically**. This would filter out some of the situations that are more akin to interest rate risk exposures from single items[17]—but some small volumes of items or transactions could technically still be considered open portfolios for which risk is managed dynamically, for example:

(a) a situation in which there are some repo transactions whereby financial assets are sold but do not qualify for derecognition so that

[16] See IAS 32.49(d).

[17] See paragraph 49.

the transaction is accounted for as a collateralised borrowing and expiring repo transactions are replaced with new ones.

(b) arrangements related to in substance defeasance, sinking funds and linked offset accounts that allow redraws.

53. If the Board wants to limit the scope exception by restricting it to hedges of interest rate risk that arises from open portfolios that is managed dynamically, it would be best to link the scope exception to the same circumstances as the particular disclosure requirements in draft IFRS 7.23C, which were specifically developed to address the use of hedge accounting in dynamic situations.

Summary

54. A *specific* scope exception that aims to only allow continued application of IAS 39 for particular hedges could be narrowed down to broadly confine it to situations in which 'macro cash flow hedge accounting' is used today by using a cumulative set of criteria tied to:

(a) hedges of interest rate risk;

(b) risk arising from and managed on the basis of net positions; and

(c) risk arising from open portfolios that is managed dynamically.

55. However, even that design leaves:

(a) some risk of the IAS 39 hedge accounting model being available in some situations for which the scope exception would not be intended;

(b) the risk of adding complexity and time needed to develop further guidance or else accept 'interpretation risk' (ie that some aspects and knock-on effects of the scoping would turn out to be unclear if left without specific guidance).

Conclusion

56. Like the application of the IAS 39 Implementation Guidance that relates to 'macro cash flow hedge accounting' that is not restricted in terms of using a

specific scope but relies on 'natural screening'[18], any form of specific scope exception would also in effect have to rely on 'natural screening': It would probably achieve the intended outcomes in many common situations but it cannot be designed to be 'watertight'. Limiting the scope also comes at the expense of added complexity and interpretation risk. The Board would also need to consider whether re-exposure would be warranted. If the words in IFRS 7.23C were used arguably the need for re-exposure is perhaps lessened as that is not introducing a new concept into the document (albeit it is being used in a different context).

Providing a general choice between applying IAS 39 instead of IFRS 9 for hedge accounting

57. Designing a scope exception in form of a general choice between applying IAS 39 instead of IFRS 9 for hedge accounting would:

    (a) be technically straightforward and not be complex (*in terms of design*);

    (b) entail the co-existence of different hedge accounting models until the Board's project on accounting for macro hedging is finalised (and has become mandatorily effective)[19]. EFRAG acknowledged this in suggesting this alternative.

58. A scope exception in the form of a general choice between applying IAS 39 instead of IFRS 9 for hedge accounting could be provided as:

    (a) a hedge-by-hedge choice; or

    (b) a one-time accounting policy choice of the entity at the time of the mandatory effective date of IFRS 9 for hedge accounting.

59. A **hedge-by-hedge choice** would create a pick-and-choose style co-existence of different accounting models. It would impede comparability

[18] This means that there is a *natural incentive* to use that type of accounting only when it makes sense because of the effort involved, which discourages its use in other situations in which it would be less or not appropriate.

[19] The current draft hedge accounting requirements would only involve allowing continuing with the exception under IAS 39 for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities. This exception has not been commonly used in practice, and it would be an exception to any hedge accounting model.

even within an entity's own financial statements. So in the staff's view that alternative is not a serious consideration.

60. A **one-time accounting policy choice** would only have to be provided at the time of the mandatory effective date of IFRS 9 because before that date an entity is not required to apply the new hedge accounting model anyway. This choice would be available until the Board's project on accounting for macro hedging is finalised. In this context, 'finalised' would mean the mandatory effective date of the standard that would result from that project (otherwise the 'have to change twice' or 'uncertainty' argument would still be made by those entities who would not believe they would have sufficient lead time to apply the 'macro standard' before its mandatory effective date).

61. In that sense, such a one-time accounting policy choice is *equivalent* to delaying the mandatory effective date for the hedge accounting requirements of IFRS 9 not until a definite date but instead until a date that is conditional on the effective date of a standard that would result from the Board's project on accounting for macro hedging. Clearly this is an extremely open ended concept. However, the staff consider that in terms of drafting and design of the requirement this is the clearer and cleaner solution.[20]

62. An accounting policy choice for the hedge accounting model would avoid the pick-and-choose style co-existence of different hedge accounting models *at the reporting entity level* but instead limit the co-existence to different accounting policies between entities. One obvious consequence of this type of co-existence is that it diminishes comparability between entities because of the availability of different accounting models. Of course one could argue that hedge accounting is an election anyway, including in some cases different ways of how hedged items can be designated—but the co-existence of different models adds an additional dimension. It means for example that users of financial statements, auditors and regulators need to maintain the knowledge and infrastructure to be able to deal with two

[20] The remainder of this paper continues to refer to a one-time accounting policy choice but if the Board favours this alternative it should be drafted as a conditional mandatory effective date of the hedge accounting requirements of IFRS 9.

different hedge accounting models, and it creates the risk of confusion between the two. On the flip side the *number of entities* that would choose to continue to apply the IAS 39 hedge accounting requirements instead of those of IFRS 9 might not be that high. So on the one hand the impact of providing the choice might have a limited effect in terms of how widespread it would be—but on the other hand that makes it harder to justify the co-existence of the two hedge accounting models.

63. Another consequence of the co-existence of different hedge accounting models is that it would conflict with the Board's intention to limit the different combinations that could result from early adoption choices between phases of IFRS 9 as proposed in the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (ED/2012/4)[21].

64. Also, if an accounting policy choice between the IAS 39 and IFRS 9 hedge accounting models was provided,[22] the question would arise whether the scope exception for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities should still be retained for the IFRS 9 hedge accounting model as in the draft hedge accounting requirements, ie should it still be available for entities that choose to adopt the IFRS 9 hedge accounting model. Retaining the scope exception would provide further fragmentation of the use of different hedge accounting models. However, it would allow entities that use the exception under IAS 39 for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities to continue using this narrow exception awaiting the outcome of the Board's project on accounting for macro hedging, which is intended to address particularly those circumstances that result in the use of that exception. But otherwise those entities could move on and use the IFRS 9 hedge accounting model[23]. As

[21] See BC93-94 of that exposure draft.

[22] If a hedge-by-hedge choice was provided there would be no need for retaining the scope exception for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities as a *separate* scope exception.

[23] This is as envisaged by the draft hedge accounting requirements. So the question is whether that structure should continue with an 'overlay' of an additional broader policy choice for hedge accounting.

noted before[24], the use of the special hedge accounting for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities is not widespread and an exception under any model. So from a practical relevance perspective the effect of retaining that exception is likely to be small in terms of the number of entities affected—however, the impact on the affected entities could be significant.

65. From the perspective of entities that use ‘macro hedge accounting’, an accounting policy choice between the IFRS 9 and IAS 39 hedge accounting models as a whole has the disadvantage that for all their other hedging activities they could not apply the new hedge accounting model even if they regard it as superior for situations other than those in which they use macro hedging type risk management. In that sense, the accounting policy choice might appear as a ‘poison pill’ to them.

<u>Summary</u>

66. Providing a choice between applying IAS 39 instead of IFRS 9 for hedge accounting on a hedge-by-hedge basis is not a viable option because of the resulting pick-and-choose type fragmentation of the two hedge accounting models.

67. A one-time accounting policy choice of an entity on adoption of the IFRS 9 hedge accounting model is a ‘clean’ and robust option technically. However, it would conflict with the Board’s intention to narrow down the different combinations that could result from early adoption choices under IFRS 9[25] and would give rise to the complexity that generally results from the existence of alternative accounting models. It could also be perceived as a ‘poison pill’ by entities that use ‘macro hedge accounting’.

<u>Conclusion</u>

68. On the one hand, a one-time accounting policy choice between the two hedge accounting models is technically less complex and more straightforward than a *specific* scope exception that applies to particular

---

[24] See footnote 19.

[25] As explained in paragraph 61, such an accounting policy choice is equivalent to retaining a separate mandatory effective date for the hedge accounting requirements of IFRS 9.

hedges. On the other hand, it would create a much broader extent of co-existence between the two hedge accounting models, which also conflicts with the Board's intention for reforming (by reducing) early application choices under IFRS 9.

Staff recommendation and question to the Board

69. The staff consider that the main issue of the debate about providing any scope exception from the IFRS 9 hedge accounting model (beyond simply retaining the exception for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities) is one of *change management*. The Board could deal with that by providing the clarifications and assurances that the Board tentatively agreed to at its January 2013 meeting. The staff consider that the Board already has appropriately responded to feedback received on the draft hedge accounting requirements and that no other changes are needed to address the issue of whether hedge accounting would be achievable.

70. In contrast, providing any additional choices to continue to apply IAS 39 would mean that those who apply hedge accounting to their 'macro cash flow hedges' are relieved from needing to make even the limited changes (ie updating their documentation of hedging relationships and migrating to the simplified hedge effectiveness test) until the project on accounting for macro hedges is finalised. More broadly, allowing the application of IAS 39's hedge accounting would however:

(a) defer change including delaying the introduction of the improvements and benefits of the new hedge accounting model in IFRS 9; and

(b) by virtue of providing those alternatives, risk implying that 'macro cash flow hedging', or even 'proxy hedging' in a wider sense, are inconsistent with the new hedge accounting model. As the January 2013 staff paper 4B shows, the staff do not think that is the case—but the staff have a significant concern that this fear may in fact be given greater foundation if we provide grandfathering for this fact pattern. The ability to apply hedge accounting for 'proxy hedging' is a particular concern for those entities that manage a risk other than interest rate risk on a net position basis and apply 'proxy hedging', eg in the utility industry[26]. In particular, if an additional scope exception was limited to interest rate risk these entities would in contrast to banks not even have the possibility of avoiding any perceived 'uncertainty'. More generally, the staff are concerned that this may inadvertently create uncertainty for all entities that apply the new model—ie providing 'certainty' for those who want to continue to apply IAS 39 to address their concerns would come at the expense of all other entities that move on to IFRS 9.[27]

71. An additional consequence of potentially implying that 'macro cash flow hedging', or even 'proxy hedging' in a wider sense, were inconsistent with the new hedge accounting model in IFRS 9 is that it raises the question of what will happen once the project on accounting for macro hedging is finished? All scope exceptions now provided for the new hedge accounting model will then be removed—this risks that a temporary solution may have jeopardised the long-term perception of the IFRS 9 hedge accounting model (in the manner described in the preceding paragraph).

72. For those reasons the staff recommend that the Board confirms the scope of the draft IFRS 9 hedge accounting requirements, ie only to provide a scope exception for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities.[28]

73. If the Board instead wants to provide a wider choice to apply IAS 39 for hedge accounting than in the draft IFRS 9 hedge accounting requirements, the staff note the trade-off between:

[26] This is particularly problematic in that many of the benefits of the IFRS 9 hedge accounting model are for such non financial institutions.

[27] Another unintended consequence is that this approach could in addition raise the question how 'macro cash flow hedge accounting' was consistent with IAS 39 (as explained in staff paper 4B of the January 2013 IASB meeting, see paragraph 6 of that paper).

[28] See paragraph 6.1.3 of the draft hedge accounting requirements for IFRS 9.

(a) the technical complexity and interpretation risk associated with creating any specific scope exception for particular hedges (noting that developing guidance to reduce the interpretation risk would require more time and, depending on the approach taken, potentially need re-exposure); and

(b) the extent of co-existence between the two hedge accounting models, which also conflicts with the Board's intention of reducing early adoption choices under IFRS 9.

74. Depending on the personal preference of a Board member, those more concerned about aspect (a) would lean towards providing a one-time *accounting policy choice* between the two hedge accounting models whereas those more concerned about aspect (b) would lean towards providing a *specific* scope exception that applies to particular hedges.[29]

Question to the Board

Does the Board want to provide scope exceptions in addition to the one for fair value hedges of the interest rate exposure of a portfolio of financial assets or financial liabilities in the draft hedge accounting requirements?

If so, which further scope exception does the Board want to provide:

(A) a one-time *accounting policy choice* between the two hedge accounting models;

(B) a *specific* scope exception that applies to particular hedges (using the cumulative criteria set out in paragraph 54); or

(C) any other scope exception and, if so, which one, and why?

[29] See paragraph 54.

EFRAG
European Financial Reporting Advisory Group

22 March 2013

International Accounting Standards Board
Attn. Hans Hoogervorst
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir,

Request to allow hedge accounting to comply with either IAS 39 or IFRS 9 while the macro hedging project is developed

In September 2012, EFRAG initiated a field-test together with the ANC, ASCG, FRC and OIC on the Review Draft general hedge accounting. The results of the field-test were communicated to you in our letter of 17 January 2013. In that letter, we wrote that we would be undertaking a detailed analysis of the impact on macro hedge relationships of the consequential amendments proposed by the Review Draft that would be subject to full due process with our constituents. This letter reports on the findings from that analysis and the conclusions that we have drawn from it.

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

While the IASB is considering portfolio hedging strategies and developing appropriate hedge accounting to best reflect those hedging strategies, EFRAG believes no change should be mandated, so as to avoid the cost and the disruption caused by successive changes in financial reporting requirements. EFRAG therefore believes it is necessary that entities be granted the ability to maintain in all circumstances the status quo regarding existing IAS 39 compliant portfolio hedge accounting practices until the project on macro hedging is completed.

The input received from constituents in this supplementary consultation has led EFRAG to note the following:

(a) Significant uncertainty exists as to whether existing IAS 39 compliant portfolio hedge accounting practices (such as portfolio cash flow hedges, hedges based on Section F of the Implementation Guidance (e.g. F.6.2 and F.6.3) and proxy hedging) will continue to be possible under the Review Draft.

(b) There is a significant risk that entities will be required to change their IAS 39 compliant portfolio hedge accounting practices twice (i.e. once upon finalisation and adoption of the general hedge accounting requirements and once again when the macro hedging project is completed) and that entities might be required to make significant systems investments in order to meet the disclosure requirements regarding proxy hedging.

(c) The term 'macro hedging', for which there is not a single universally applied definition in practice, would need to be defined as part of the development of the discussion paper on macro hedging. The term alternatively refers to either what is being hedged – open portfolios and/or net positions that arise from them – or the hedge accounting technique that is used – transaction-by-transaction or otherwise. Furthermore, we note that defining a 'macro hedge' as a hedge of an open portfolio may not be the most appropriate approach as most closed portfolios can easily be made 'open'; thereby rendering the definition ineffectual for the purpose of setting the scope of standards.

(d) The respondents in the field-test confirmed that the Review Draft introduces important improvements in the hedge accounting requirements such as: (a) improvements in the hedge effectiveness testing requirements; (b) the treatment of the time value of options and the treatment of forward points; (c) the possibility to designate aggregated exposures as eligible hedged item; (d) the ability to designate risk components as an eligible hedged item; and (e) the ability to rebalance hedge relationships.

EFRAG has considered several approaches including those suggested by constituents on how the above issues might be best addressed:

(1) *To modify the wording of paragraph 6.1.3 of IFRS 9 to allow for current hedging requirements applicable to open portfolios to be available under what remains of IAS 39* – This could lead to a very open-ended scope out from the IFRS 9 hedge accounting requirements, as the notion of open portfolio hedging is not well-defined and potentially very broad (as noted under (c) above); in contrast with portfolio fair value hedge of interest risk, cash flow hedge accounting is dealt with in both IFRS 9 and IAS 39; if this approach were to be adopted, the IASB would have to define how to robustly ring-fence the option;

(2) *To carry over to IFRS 9 the implementation guidance in Section F related to portfolio hedging* – This approach would not fully address concerns, because to the extent that parts of Section F are consistent with IFRS 9, it would not provide any relief. And where Section F is inconsistent with IFRS 9, it would not be possible to incorporate it.

(3) *To grant a temporary exemption from IFRS 9* – The hedge accounting requirements in IFRS 9 align hedge accounting more closely with risk management, resulting in more useful information to users. However, under this alternative, entities would not need to demonstrate the link to risk management in the way currently envisaged by IFRS 9 (but would nonetheless provide some sort of documentation and disclosure). Therefore, this alternative has the shortcoming of sacrificing a newly developed and widely praised principle for a subset of entities; and

(4) *To grant an option, each entity having the choice to comply with IAS 39 or IFRS 9 (as per the Review Draft) for hedge accounting in its entirety.* This option ensures that the status quo can be maintained. It has the drawback from the point of view of many European banks – particularly those that favour option 1 – that it is considered to be radical and to deprive them from the benefits that IFRS 9 could bring outside the remit of portfolio hedging.

EFRAG has concluded that the most straightforward and practical way of ensuring that existing IAS 39 compliant portfolio hedging practices would not be affected by the Review Draft would be to provide entities a simple choice to either (1) retain IAS 39 hedge accounting for all of their hedges until either they decide to apply IFRS 9 irreversibly or the project on macro hedging is completed or (2) to adopt irreversibly the requirements of the Review Draft as drafted (including the exception in paragraph 6.1.3 on portfolio fair value hedges of interest rate risk).

This approach provides certainty that entities can continue to apply IAS 39 compliant portfolio hedging practices until the project on macro hedging is completed, without incurring the cost of considering whether their current IAS 39 compliant practices are compliant with IFRS 9 and without running the risk of having to incur the costs of changing their portfolio hedge accounting twice. In addition, it avoids:

(a) the complexity that would arise from the interaction between the scope and the requirements of IAS 39 and IFRS 9;

(b) the potential drawbacks of grandfathering IAS 39 practices into IFRS 9 without due consideration;

(c) the risk of giving rise to an accounting approach that mixes-and-matches elements of IAS 39 and IFRS 9 on a transaction-by-transaction basis; and

(d) any tainting of the fundamental objective of IFRS 9 that hedge accounting should reflect risk management practices.

It has been argued that a drawback of this approach would be that it reduces comparability between those who would apply IFRS 9 and others that continue to apply IAS 39 for their hedge accounting. However, we note that under both IAS 39 and IFRS 9: (1) establishing hedge relationships between derivatives and underlying positions is not mandatory and (2) hedge relationships between the same derivatives and underlying positions can be articulated in many different ways. Therefore, EFRAG believes that the cost of changing portfolio hedge accounting twice would outweigh the potential reduction in comparability.

In the course of this supplementary consultation with stakeholders, EFRAG constituents have highlighted the significant improvements that hedge accounting under IFRS 9 brings compared to IAS 39. EFRAG does not want to discourage the IASB from developing a solution along the lines of approach (1) above (i.e. ring-fencing macro hedge accounting), as this would make the benefits of IFRS 9 available to the greatest number of constituents possible. However, so far we have not been able to identify a workable approach that we could recommend to you. In the absence of such a possibility, we consider that the option to apply IAS 39 must remain available.

Also, the majority of entities – that benefit from the improvements that the IFRS 9 hedge accounting requirements bring – would not be required to wait for the completion of the macro hedging project before being able to apply the new requirements.

Finally, EFRAG believes that macro hedging is important for European financial institutions and needs to be put on a solid conceptual footing. Therefore, we need the IASB to continue with its macro hedging project and to consider without prejudice both fair value hedge accounting and cash flow hedge accounting. While we note that IASB's discussions to date on the macro hedging project have focused on macro fair value hedging for interest rate risk, we believe that IASB should fully consider all aspects of macro hedge accounting – and its definition – without further delaying finalisation of IFRS 9.

If you would like to discuss our comments further, please do not hesitate to contact Didier Andries, Marc Labat or me.

Yours sincerely,

Françoise Flores
EFRAG Chairman