# STAFF PAPER

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**IASB Meeting**

| **Project** | **Hedge Accounting (IFRS 9)** | | |
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| Paper topic | Measurement of the hedged item—'hypothetical derivatives': staff recommendation and question to the Board | | |
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## Introduction

1. This paper provides the staff recommendation regarding the requirements for the use of hypothetical derivatives and asks the Board whether it wants to revisit its tentative decision and, if so, what alternative it prefers instead.

## Staff recommendation

2. The staff acknowledge that the discussion of using a hypothetical derivative has many aspects and is a complicated one. In order to assist the Board in its decision making, the staff:

   (a) develop alternative ways for how the Board could address this issue; and

   (b) set out the aspects that are relevant for assessing those alternatives.

### *Decision relevant aspects*

3. The staff consider the following aspects to be relevant:

   (a) **model fit**: how the use of hypothetical derivatives fits into the new hedge accounting model;

(b) **information usefulness** (including transparency); and

(c) **operational simplicity**: the simplicity of applying the accounting treatment.

4. These aspects will be evaluated in conjunction with each of the alternatives that are discussed in the next section.

## *Alternatives for addressing the use of hypothetical derivatives*

5. The staff consider that the Board has the following alternatives for addressing the use of hypothetical derivatives:

(a) finalise the draft hedge accounting requirements of IFRS 9 *Financial Instruments* as they are;

(b) allow the use of hypothetical derivatives to be continued in way that grandfathers existing practice; or

(c) expand the notion of 'costs of hedging' to accommodate FX basis spreads.

### *Finalise the draft hedge accounting requirements of IFRS 9 as they are*

6. The first alternative is to proceed with the draft requirements without changes regarding the use of hypothetical derivatives. The assessment of this alternative against the decision-criteria is as follows:

7. **Model fit**: the requirement as drafted fits into the hedge accounting model in that it is consistent with:

(a) a valuation approach; and

(b) a measurement of the hedged item that is independent of the hedging instrument.

Consequently, this alternative results in capturing hedge ineffectiveness from *all* sources (ie including credit risk as well as liquidity of instruments etc).

8. However, as noted in the staff analysis[1], if you consider the FX basis spread as a cost of hedging then not being able to account for it under the notion of 'costs of hedging' in the new model would be inconsistent.

9. Another aspect of the model fit is that the requirement as drafted would *mitigate the accounting arbitrage* between designations of hedging relationships as a cash flow hedge versus a fair value hedge.[2] The incentive to split the designation of hedging relationships for fixed rate debt denominated in a foreign currency into several hedging relationships *solely in order to* use a cash flow hedge designation that, by using a 'hypothetical derivative', would avoid hedge ineffectiveness arising from the FX basis spread, would fall away. In other words, the first alternative would mitigate the accounting arbitrage by requiring that hedge ineffectiveness from the FX basis spread arises for *both* cash flow hedge and fair value hedge designations reflecting that the economic position is identical.

10. **Information usefulness**: the general design of the model aimed to create principles that result in the provision of useful information. Exceptions to the model were created in some circumstances when it improved the usefulness of information provided.

11. This background is particularly important to the issue in question. If you do *not* consider the FX basis spread as a cost of hedging then the requirements as drafted provide useful information. Consequently, in that case the FX basis spread should not be treated like 'costs of hedging', which means it should affect the financial statements like other differences between the features and characteristics of the hedging instrument and the hedged item (eg credit risk) that are portrayed as hedge ineffectiveness.

12. Conversely, if you consider that the FX basis spread *is* a cost of hedging then the accounting for 'costs of hedging' in the new model would provide better information because it was designed to address this particular aspect. In particular, it would be appropriate to provide transparency for the effect of the FX basis spread, which would otherwise be mingled with the effect of

[1] See paper 4A2, paragraphs 34-38.

[2] See paper 4A2, paragraph 43.

sources of ineffectiveness (and hence not be discernible for readers of the financial statements). In other words, if you think investors draw different conclusions from valuation mismatches attributable to the FX basis spread than those attributable to other sources (eg credit standing of the individual counterparties to the hedging instrument or mismatches in the cash flow variability of the hedging instrument and the hedged item) the FX basis spread should *not* be mingled with the latter.

13. Another aspect relates to the accounting arbitrage between cash flow hedge and fair value hedge designations discussed under the model fit:[3] if that arbitrage is not desirable or acceptable for you then the first alternative has the advantage of improving comparability because it mitigates that arbitrage.[4] The FX basis spread would cause hedge ineffectiveness irrespective of whether a hedging relationship is designated as a fair value hedge or as a cash flow hedge.

14. **Operational simplicity**: the requirement as drafted is more complex than the use of a hypothetical derivative that mirrors the FX basis spread in the actual hedging instrument. In measuring the hedged item, mirroring the FX basis spread allows using discount curves that are the same for the hedging instrument and the hedged item.

15. In contrast, the requirements as drafted would result in using a different discount curve for the hedged item and the hedging instrument.

16. Other considerations regarding operational simplicity are:

    (a) The method used for including credit risk in valuations: if an entity includes the effect of credit risk in valuations by adjusting the discount rate it has to use different discount rates for the hedging instrument and the hedged item in order to capture credit risk (except when the credit risk is exactly the same for the hedging instrument

[3] See paragraph 9.

[4] The third alternative would also mitigate this arbitrage (see paragraph 43) but in a different way (using accounting for 'costs of hedging').

and the hedged item); if an entity uses a different method[5] then credit risk can be captured without an adjustment to the discount rates (in that case being allowed to mirror the FX basis spread would be beneficial from an operational complexity perspective).

(b) The availability and use of valuation inputs: FX basis spreads are a type of financial information that has become available from data services providers, similarly to information about various discount rates, security prices etc. In addition, the discount curve that would have to be used under the draft requirements (ie excluding the FX basis spread) is at least as available from data services providers.[6] In addition, entities that need to value any item in the same foreign currency that the hedged item is denominated in already need to have the discount curve that would have to be used under the draft requirements.

(c) For all hedging relationships in which the variable cash flows of the hedging instrument and the hedged item do not exactly offset, the hypothetical derivative would result in a separate calculation anyway. (However, as highlighted by the feedback, in practice it is common that the variable cash flows for hedges of debt instruments denominated in a foreign currency with CCIRSs are matched.)

(d) The general concept of materiality in IFRSs can be applied to address mismatches in valuation inputs that do not have a material effect.

(e) The use of cross-currency swaps to hedge FX risk is widespread so a wide range of entities (with varying levels of sophistication) is affected.

[5] In practice, adjusting discount rates for including credit risk in valuations is becoming increasingly less common. The use of methods based on estimates of future exposures, probability of default and loss given default is becoming more common.

[6] Of course not all entities use information provided from external data services providers but some entities construct their own discount curves to generate valuation inputs. That is an economy of scale question but the fact that it is economical for an entity to construct its own discount curves suggests that this type of input is available anyway (ie does not require an incremental effort in response to one more transaction or an accounting requirement), and in a form that allows including it in the entity's valuation systems.

*Grandfathering existing practice*

17. The second alternative is to allow the existing practice of using hypothetical derivatives to continue. This alternative raises the question of how exactly that 'grandfathering' should be done:

    (a) *A general endorsement of 'existing practice'* is not a viable alternative because it is impossible to know how each entity is using hypothetical derivatives, which means that the Board would not know what it allows or grandfathers.

    (b) The Board could *change the draft requirement* by allowing hypothetical derivatives to be constructed as the 'perfect derivative'. In that case the Board would need to clarify what 'perfect' means, which is not trivial (as explained before[7]). The staff consider that 'perfect' is a misnomer in that context and the Board would have to clarify which particular way of constructing a hypothetical derivative it wants to allow:

        (i) Simply using the *same discount curve* that is used for valuing the actual hedging instrument also for the hypothetical derivative. This alternative would conceal hedge ineffectiveness from changes in credit risk affecting the hedging instrument or hedged item[8] but capture the effect of mismatches between their variable cash flows.

        (ii) Using the same *type* of valuation inputs *for market rates or prices* that are used for valuing the actual hedging instrument also for valuing the hypothetical derivative. This alternative would capture hedge ineffectiveness from changes in credit risk affecting the hedging instrument or hedged item as well as mismatches between their variable cash flows.

[7] See paper 4A3, section "The hypothetical derivative is the 'perfect derivative'".

[8] For the same reason as the "hypothetical-derivative method" under US GAAP does (see paper 4A3, footnote 16).

(c) The Board could *remove guidance on hypothetical derivatives*.[9] However, only removing the second half of paragraph B6.5.5 of the draft hedging accounting requirements, as suggested by some, would not work because it explains the consequences of the draft requirements for how hypothetical derivatives could be used. Those consequences would obviously not change by simply removing the illustration of their effect (ie that a feature of the hedging instrument that does not exist in the hedged item cannot be included in the hypothetical derivative). So removing only part of the draft guidance on hypothetical derivatives might make the requirements less clear but would *not change* them. Instead, the Board would have to remove the *entire* draft guidance on hypothetical derivatives.[10] *But even if* the entire guidance on hypothetical derivatives was removed, an entity that applies IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to develop an accounting policy for its use of hypothetical derivatives would have to consider the aspects discussed earlier[11] in terms of whether and to what extent using a hypothetical derivative would be consistent with the hedge accounting model. That essentially means that a hypothetical derivative could only be used in the sense that the draft requirements have set then out (but which would be deleted) or else entities would face a situation in which their accounting policy would at the least be very vulnerable to challenges under IAS 8.[12]

18. **Model fit**: grandfathering a use of hypothetical derivatives that is inconsistent with the draft requirements does *not* fit into the hedge accounting model in that it is inconsistent with:[13]

(a) the notion of 'costs of hedging';

[9] This would result in a situation more similar to IAS 39 *Financial Instruments: Recognition and Measurement*, which is not explicit on the construction of hypothetical derivates.

[10] That means omitting paragraphs B6.5.5 and B6.5.6 from the final hedge accounting requirements (and omitting the related Basis for Conclusions, ie paragraphs BC195-BC198).

[11] See paper 4A2, section "Risk management view: the hypothetical derivative as the 'perfect derivative'".

[12] That already reflected in the fact that there are different views today (see paper 4A3, paragraph 4).

[13] See paper 4A2, section "Risk management view: the hypothetical derivative as the 'perfect derivative'".

(b) the notion of hedge ineffectiveness; and

(c) the principle of measuring the value of the hedged item independently of the value of the hedging instrument.

Consequently, this alternative results in capturing hedge ineffectiveness from *some but not all sources*. For example, it would not capture hedge ineffectiveness from the aspects that drive the FX basis spread (such as the liquidity of instruments etc), but would capture that which arises from mismatches between the variable cash flows of the hedging instrument and the hedged item and—depending on a clarification[14]—credit risk).

19. However, as discussed earlier,[15] if you consider the FX basis spread as a cost of hedging then you could argue that not being able to account for it under the notion of 'costs of hedging' would be inconsistent with the new model. *But* the logical consequence of this argument would be to accommodate accounting for the FX basis spread as 'costs of hedging' (instead of using a hypothetical derivative that imputes an FX basis spread into the hedged item).[16] That also relates to a difference in the accounting outcome between the second and the third alternative regarding when hedge accounting is discontinued:

(a) Using a hypothetical derivative that imputes an FX basis spread into the hedged item means that on discontinuation of hedge accounting the requirements for discontinued cash flow hedges apply. Consequently, the value changes attributable to the FX basis spread that have been accumulated in AOCI will be reclassified to profit or loss over the remaining term of the original hedging relationship. In other words, costs of hedging are still deferred in AOCI to future

[14] See paragraph 17(b)(ii).

[15] See paragraph 8.

[16] In other words, this would lead to the *third* alternative that is discussed in the section "Expand the notion of 'costs of hedging'".

periods even though the CCIRS that would cause those costs might no longer exist (and hence those costs not arise)[17].

(b) Using the accounting for 'costs of hedging' means that if hedge accounting for the hedged debt is discontinued, the value changes attributable to the FX basis spread that have been accumulated in AOCI would be immediately reclassified to profit or loss.[18] This reflects the essence of the notion of 'costs of hedging', which means those costs can only be deferred and allocated to periods for which (and as long as) those costs actually arise and the items they relate to still qualify for hedge accounting.

20. Another aspect of the model fit is that grandfathering existing practice would *perpetuate the accounting arbitrage* between designations of hedging relationships as a cash flow hedge versus a fair value hedge. This aspect is already discussed under the first alternative[19] and the same considerations apply here (but in the opposite way, eg hedge ineffectiveness from the FX basis spread would arise in a fair value hedge designation but could be avoided in a cash flow hedge designation).

21. **Information usefulness**: as for the first alternative, the assessment comes down to whether:

(a) you do *not* consider the FX basis spread as a cost of hedging, in which case using a hypothetical derivative that includes an FX basis spread would conceal hedge ineffectiveness; or

(b) you consider that the FX basis spread *is* a cost of hedging, in which case the hedge ineffectiveness resulting from excluding an FX basis spread from the hypothetical derivative would mischaracterise costs of hedging as hedge ineffectiveness.

[17] But at least it would no longer qualify for hedge accounting in that original hedging relationship even if retained by the entity so still applying the notion of 'costs of hedging' would lose its justification.

[18] The treatment would be similar to that in draft IFRS 9.6.5.16 and 6.5.15(c), for the purposes of which the hedged item would be a time-period related one (see draft IFRS 9.B6.5.30).

[19] See paragraph 9.

22. However, when using a hypothetical derivative that includes an FX basis spread, costs of hedging would be characterised as an offsetting value change (an 'effective hedge'[20]), which could be considered a different kind of mischaracterisation. So essentially the decision would be about which of two possible mischaracterisations of an FX basis spread (as either hedge ineffectiveness or hedge effectiveness)[21] is less concerning to you.

23. Another consideration is the transparency of the accounting for the effect of the FX basis spread. Both (mis)characterisations would result in mingling that effect with something else:

    (a) either the effect of sources of hedge ineffectiveness; or

    (b) the effect of characteristics that result in offsetting changes between the value of the hedging instrument and the hedged item (ie the drivers of the effective part of the hedging relationship).

24. *Either way*, the effect of costs of hedging resulting from the FX basis spread would *not* be discernible for readers of the financial statements. In other words, if you think investors draw different conclusions from valuation mismatches attributable to the FX basis spread than those attributable to other factors than costs of hedging then the FX basis spread should not be mingled with those.

25. The accounting treatment when hedge accounting is discontinued[22] is also a consideration, ie whether you consider deferring costs of hedging in AOCI even after hedge accounting is discontinued provides useful information.

26. Another aspect relates to the accounting arbitrage between cash flow hedge and fair value hedge designations discussed under the model fit:[23] if that arbitrage is not desirable or acceptable for you then the second alternative

[20] That reflects the perspective that the hypothetical derivative is the 'perfect derivative' but that conflicts with the new hedge accounting model's notion of 'costs of hedging' (see paper 4A2, paragraph 25).

[21] Obviously the difference between those two characterisations is significant as it means concurrent recognition in profit or loss versus deferral in AOCI.

[22] See paragraph 19.

[23] See paragraph 20.

has the disadvantage of impairing comparability because it perpetuates that arbitrage.

27. **Operational simplicity**: the discussion of the operational simplicity for the first alternative already contrasts the first two alternatives.[24] Hence, the same considerations apply here (but in the opposite way).

28. One additional aspect is that even the second alternative would *not* achieve the same accounting outcome as US GAAP *unless* the Board allowed simply using the *same discount curve* that is used for valuing the actual hedging instrument also for the hypothetical derivative (and hence that hedge ineffectiveness from changes in credit risk affecting the hedging instrument or hedged item would be concealed)[25].

### *Expand the notion of 'costs of hedging'*

29. The third alternative is to accommodate accounting for 'costs of hedging' for an FX basis spread. There are several ways the notion of 'costs of hedging' could be expanded to achieve this:

    (a) by *adding* a third exception to the existing ones (the time value of options and the forward element of forward contracts);

    (b) by *broadening* the exception for the forward element of forward contracts to include FX basis spreads; or

    (c) by *replacing* the existing exceptions with a 'costs of hedging' principle.

30. Replacing the existing exceptions with a principle would mean establishing the notion of 'costs of hedging' more generally with the exceptions becoming examples (instead of being an exhaustive list).

31. **Model fit**: whether expanding the notion of 'costs of hedging' fits into the hedge accounting model again depends on whether you consider the FX basis spread to be a cost of hedging.

[24] See paragraphs 14-16.

[25] See paragraph 17(b)(i).

32. Arguably, if you think that ‘costs of hedging’ is a wider economic phenomenon and that (separate) information about it is useful then the *conceptual implication* for the accounting model design is that it should be a *principle*. Introducing the notion of ‘costs of hedging’ as a principle (instead of using an exhaustive list) has also been suggested in some of the feedback received on the draft requirements.

33. However, the feedback on the use of hypothetical derivatives reflects a strong tendency to assume that ‘hedges are perfect’ and that those using the best hedge available should not be ‘punished’ with volatility in profit or loss. In addition, the severe economic crisis that began in 2007 has significantly changed the derivative markets in a way that the pricing does not behave as expected for a ‘perfect’ market[26], which means that hedging relationships that were very effective before now involve a higher degree of hedge ineffectiveness. This results in a strong pressure on entities to find different ways of designating those hedging relationships for hedge accounting purposes in order to counter the additional hedge ineffectiveness that the market changes brought about.

34. Against that background, using a new notion like ‘costs of hedging’ as a broad principle involves the risk of entities using it too widely to defer in AOCI as ‘costs of hedging’ any amounts from mismatches between the characteristics of the hedging instrument and the hedged item (at least to the extent that the entity considers those ‘unavoidable’), which means hedge ineffectiveness could at least in part end up being deferred in AOCI. This danger was acknowledged in some of the feedback received.

35. Expanding the notion of ‘costs of hedging’ would result in a different outcome than the second alternative (ie ‘grandfathering’) in situations in which hedge accounting is discontinued. That aspect is already included in the discussion of the second alternative[27] and the same considerations apply here.

[26] In particular the actual existence of price differentials that should be eliminated by arbitrage transactions in accordance with economic theory but that remain in the actual markets.

[27] See paragraph 19.

36. The staff think that expanding the notion of 'costs of hedging' would be achieved in a way that fits best into the hedge accounting model by:

    (a) expanding the existing draft requirement regarding the forward elements of forward contracts[28] so that it also covers FX basis spreads; and

    (b) aligning the structure with that used for the time value of options, ie regarding the notion of time-period and transaction related hedged items.

37. The staff consider this way of expanding the notion of 'costs of hedging' fits best into the new hedge accounting model because:

    (a) it would combine the requirements for FX basis spreads irrespective of which type of derivative they relate to (ie cross-currency swaps or forward contracts) whereas adding a separate third type of a cost of hedging would cause confusion between that third type and the existing draft requirement regarding the forward elements of forward contracts;

    (b) it would avoid unintended consequences if there were any cases in which the FX basis spread implicit in a 'normal' FX forward contract would be material.[29]

38. Another aspect of the model fit is that expanding the notion of 'costs of hedging' would *mitigate the accounting arbitrage* between designations of hedging relationships as a cash flow hedge versus a fair value hedge. But in contrast to the first alternative, the third alternative would mitigate the accounting arbitrage in that the effect of the FX basis spread on the change in fair value of the CCIRS is recognised in OCI for *both* cash flow hedge and fair value hedge designations.

[28] Included in the draft requirements as paragraph 6.5.16.

[29] In other words, this would ensure that an entity using a 'normal' FX forward contract could get an accounting outcome that is *consistent* with that of an entity using an FX option and using the accounting for the time value of options as costs of hedging, for example when both entities hedge the FX risk of a forecast purchase of property, plant and equipment.

39. **Information usefulness**: again, similarly to the discussion of the first alternative, the assessment comes down to whether you consider the FX basis spread to be a cost of hedging.

40. Another consideration is the transparency of the accounting for the effect of the FX basis spread. The third alternative would be the most transparent. Expanding the notion of 'costs of hedging' would *avoid mingling* the effect of the FX basis spread on the valuation of the derivative with other items[30].

41. Under this alternative, the effect of costs of hedging resulting from the FX basis spread *would be discernible* for readers of the financial statements. In other words, if you think investors draw different conclusions from valuation mismatches attributable to the FX basis spread than those attributable to other factors than costs of hedging then the accounting as 'costs of hedging' would provide transparency.

42. The accounting treatment when hedge accounting is discontinued[31] is also a consideration, ie whether you consider immediate reclassification of costs of hedging to profit or loss when hedge accounting is discontinued provides useful information.

43. Another aspect relates to the accounting arbitrage between cash flow hedge and fair value hedge designations discussed under the model fit:[32] if that arbitrage is not desirable or acceptable for you then the third alternative has the advantage of improving comparability because it mitigates that arbitrage.

44. **Operational simplicity**: the discussion of the operational simplicity for the first alternative already contrasts the first two alternatives.[33] Given that the accounting for the *hedged item* would be the same under the first and the third alternative, the same considerations also apply here.

[30] See paragraph 23.

[31] See paragraph 35.

[32] See paragraph 38.

[33] See paragraphs 14-16.

45. One additional aspect is that the third alternative would involve separate accounting for the effect of the FX basis spread on the valuation of the hedging instrument. However:

(a) If the variable cash flows of the hedging instrument and the hedged item 'perfectly' offset, entities would already have the information needed for applying the accounting for 'costs of hedging'. The reason is that the critical terms of the hedging instrument are then aligned with those of the hedged item. Consequently, the difference between the valuation used for the 'hypothetical derivative' under the practice of including an FX basis spread and the valuation of the hedged risk under the new requirements (ie excluding an FX basis spread) would be the effect of the FX basis spread, which are the 'costs of hedging'. Therefore, the additional operational complexity compared to the first alternative would be to *retain* the construction of the currently used hypothetical derivative in addition to constructing a hypothetical derivative without the FX basis spread. Entities that use a method for including credit risk in the fair value measurement other than by adjusting the discount rate[34] would not even have to retain additional information as for them the hypothetical derivative that includes the FX basis spread in a situation in which the variable cash flows of the hedging instrument and the hedged item 'perfectly' offset would be the same[35] as the actual derivative before the credit risk adjustment. The feedback highlighted that when using CCIRSs to hedge debt denominated in a foreign currency the critical terms are typically aligned (ie the variable cash flows offset).[36]

(b) If the variable cash flows of the hedging instrument and the hedged item do *not* 'perfectly' offset, an entity needs a separate valuation for the hedged item anyway—even under the practices described in the feedback. In that case the entity would have to compare the effect of

[34] See paragraph 16(a).

[35] Except for the sign (ie positive or negative, depending on the entity's system implementation).

[36] See paragraph 16(c).

the FX basis spread in the actual hedging instrument with the effect of the 'aligned' FX basis spread of the hedged item. This means the entity has to isolate the effect of the FX basis spread on the valuation of both the hedging instrument and the hedged item. The additional complexity that results depends on what valuation tools and entity uses (eg some modern valuation tools allow including or excluding individual valuation inputs or varying the input values like in a sensitivity analysis).

46. Also, as the discussion of the accounting arbitrage[37] shows, the desire to reduce volatility in profit or loss creates an incentive for entities that currently results in *voluntarily* increasing the operational complexity for hedging relationships by splitting them into several different designations. This requires more hedging relationships to be documented, tracked, accounted for (from journal entries to disclosures) and, in particular, increases the number and different types of valuations that are necessary.

### *Summary*

47. The debate about the use of hypothetical derivatives is in essence one about their purpose, which also reflects two fundamentally different views of the nature of hedge accounting—is a hypothetical derivative meant to represent:

    (a) **View A**: the 'perfect *hedge*'; or

    (b) **View B**: the hedged item?

48. Those views lead to different conclusions regarding what factors cause hedge ineffectiveness and what are costs of hedging.

49. View A could be considered to take a 'synthetic' view of the result in profit or loss that should result from the hedging instrument and the hedged item considered together as one package. Consequently, it includes the costs of hedging as an integral aspect instead of viewing them as a difference between the hedging instrument and the hedged item. In the extreme, this view leads to a 'change in variable cash flows' method and not recognising

[37] See paper 4A2, paragraph 42.

the effect of credit risk as long as the hedging relationship qualifies for hedge accounting. However, other variations of this view would recognise hedge ineffectiveness from the effect of credit risk even if the hedging relationship still qualifies for hedge accounting. However, for fair value hedges this view does not work, which means this view considers cash flow hedges and fair value hedges as fundamentally different (including the measurement of the hedged item).

50. View B regards hedge accounting as a concept that is based on comparing two items that are each measured separately. It looks *directly* at the hedged item without involving the notion of a 'perfect hedge' and only considers a hypothetical derivative as a tool to measure the value of the hedged item. The hedging instrument is the one that the entity actually uses, so thinking about what might have been a better hedging instrument is irrelevant. This view is consistent with a hedge accounting model that:

    (a) is a valuation model; and

    (b) one in which the value of the hedged item is measured independently of the value of the hedging instrument.

    Because this view is consistent with a valuation model, the difference between a fair value hedge and a cash flow hedge is not as fundamental as under View A.[38]

51. These different views are the background of the *3-way trade-off* that results from the three decision relevant aspects, ie:

    (a) model fit;

    (b) information usefulness; and

    (c) operational simplicity.

52. The weighting of the importance of those aspects and whether you consider the FX basis spread as a cost of hedging determine which one of the alternatives in this paper is preferable:

[38] In particular, whether the hedged item is valued independently of the hedging instrument is not a differentiator under this view, but only the aspects discussed in paper 4A2, paragraphs 11-12.

(a) **Alternative A**: finalise the draft hedge accounting requirements of IFRS 9 as they are;

(b) **Alternative B**: allow the use of hypothetical derivatives to be continued in way that grandfathers existing practice either by:

(i) allowing the same credit risk adjustment to be used as for the valuation of the actual hedging instrument[39]; or

(ii) requiring the effect of credit risk to be measured independently for the hedging instrument and the hedged item[40].

(c) **Alternative C**: expand the notion of 'costs of hedging' so as to accommodate FX basis spreads:

(i) by expanding the existing draft requirement regarding the forward elements of forward contracts so that it also covers FX basis spreads and aligning the structure with that used for the time value of options[41], or

(ii) by replacing the exceptions with a general principle.

53. The staff consider that the FX basis spread is a cost of hedging. Therefore, on balance, while the staff acknowledge that this involves additional operational complexity, the staff recommend Alternative C because it provides the most transparent solution that best reflects the economics of the transaction and it fits into the new hedge accounting model. Regarding the two variations of Alternative C, the staff recommend expanding the existing draft requirement regarding the forward elements of forward contracts[42]. The staff acknowledge that the conceptual implication for the accounting model design is that it should be a principle but think that it is outweighed by the concerns about the risk of entities using it too widely to defer in

[39] See paragraphs 17(b)(i) and 28. This would be equivalent to the "hypothetical-derivative method" under US GAAP (see paper 4A3, paragraph 8(c)).

[40] See paragraphs 17(b)(ii) and 28.

[41] See paragraph 36.

[42] See paragraph 52(c)(i).

AOCI as 'costs of hedging' any amounts arising from mismatches between the characteristics of the hedging instrument and the hedged item.[43]

## Question for the Board

| Question on the use of hypothetical derivatives |
| --- |
| Does the Board agree with the staff recommendation to expand the notion of 'costs of hedging' so as to accommodate FX basis spreads by expanding the existing draft requirement regarding the forward elements of forward contracts?<br><br>If the Board does not agree, which alternative (and variation, where applicable) does the Board prefer, and why? |

[43] See paragraph 34.