IFRS™

STAFF PAPER

29 January – 1 February 2013

IASB Meeting

Project	Hedge Accounting (IFRS 9)		
Paper topic	Scope and interaction with macro hedging activities		
CONTACT(S)	Martin Friedhoff	mfriedhoff@ifrs.org	+44 (0)20 7246 6410

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

1. An issue that was frequently raised by banks commenting on the draft hedge accounting requirements for IFRS 9 *Financial Instruments*[1] was 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. This paper:

   (a) provides an analysis of the issue; and

   (b) asks the Board whether it wants to

      (i) revisit its tentative decision and, if so, what alternative it prefers instead;

      (ii) make clarifications when finalising the requirements.

Feedback received

3. The feedback received can broadly be categorised as follows:

[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).

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

(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* like the accounting for a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (also colloquially referred to as 'macro fair value hedge accounting'). Those commentators suggested that this grandfathering should be achieved by retaining the related Implementation Guidance Q&As (IGs)[3] that accompany IAS 39 *Financial Instruments: Recognition and Measurement*.

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

(i) The need to use designations that do not exactly represent the actual risk management, colloquially referred to as 'proxy hedging'[4]. In particular, using a gross designation when risks are actually managed on a net position basis and using designations of variable rate debt instruments when risk management is actually based on the interest rate risk of fixed rate debt instruments.

(ii) Discontinuation of hedge accounting: some commentators perceived paragraph B6.5.24(b) of the draft as suggesting the discontinuation of hedge accounting applied on an 'all-

[2] **Usage note**: this term is colloquially used to refer to the accounting illustrated in the Implementation Guidance that accompanies IAS 39 (see footnote 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 it is a misnomer in that IAS 39 does *not provide a special accounting treatment* for macro cash flow hedging, which means this accounting is allowed *only 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 *a cash flow hedge* and the implication as if there were different 'macro' and 'micro' cash flow hedge accounting treatments is misleading—instead, cash flow hedges can be applied in different circumstances and the respective designations naturally reflect those circumstances (which is not unique for this particular circumstance but applies to other circumstances of other entities as well).

[3] Those are IGs F.6.1-F.6.3.

[4] **Usage note**: this paper uses references to 'proxy hedging' in that sense. (Sometimes 'proxy hedging' is also used as a reference to hedging relationships in which the underlyings of the hedged item and the hedging instrument are not the same but correlated. That is an entirely different issue that neither relevant nor addressed here.)

or-nothing' basis to all hedging relationships under the dynamic risk management strategy.

(iii) Some commentators believed that 'deleting' the IGs related to 'macro cash flow hedge accounting' created the impression of their rejection by the Board, ie that they would no longer apply or the accounting treatment they illustrate was no longer allowed.

(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 apply or only the specific paragraphs of IAS 39 that are cited in paragraph 6.1.3 of the draft.

Staff analysis

Grandfathering 'macro cash flow hedge accounting'

4. When considering the request for *grandfathering* 'macro cash flow hedge accounting' it is useful to recapitulate the scope and structure of the new hedge accounting model:

(a) The new hedge accounting model *does apply* to situations in which entities manage risk in a 'macro' context, eg for risk exposures that result from large groups of items that are managed on an aggregated level and including open portfolios. It also applies to all types of hedges and risks. *But* entities must use the designations that are available under the new hedge accounting model (and can only apply hedge accounting if they meet the qualifying criteria).

(b) Notwithstanding that the new hedge accounting model applies to situations in a 'macro' context, it does *not provide specific 'customised' solutions* that would be a departure from (instead of an application of) the model and make the implementation of hedge

accounting in those situations easier,[5] eg it does not allow a net position cash flow hedge for interest rate risk or allow non-interest bearing demand deposits to be designated as hedged items.

(c) The scope of the new hedge accounting model provides an *exception* that allows entities to apply IAS 39 for a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities. That scope exception relates to an accounting treatment that is *already an exception* to the hedge accounting model in IAS 39, which is strictly limited to that particular type of hedge. The Board tentatively decided to continue to permit this exception in the light of its ongoing project on accounting for macro hedging. Given that this exception does not fit into the new hedge accounting model a scope exception was the logical design for standard setting purposes.

(d) The new hedge accounting model does *not* include a scope exception for 'macro cash flow hedge accounting'. This is consistent with IAS 39. Cash flow hedge accounting in a 'macro' context was already *a way of applying* the (general) hedge accounting model under IAS 39 (it was thus an application of the model *in contrast to* the fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities). The Board did not want to change that model design by creating an exception for cash flow hedges in a 'macro' context in the new hedge accounting model.

5. Consequently, the scope is as it was intended. Those commentators who advocate *grandfathering* disagree with the model design that requires cash flow hedges to transition to the new hedge accounting model (but instead want to continue applying IAS 39).

6. From a standard setting perspective, using *grandfathering* would also create the danger of an unintended consequence *if* the Board agrees with the

[5] This is what the draft Basis for Conclusions means when it says "The Board decided not to address open portfolios or 'macro' hedging (ie hedging at the level that aggregates portfolios) as part of the exposure draft" (paragraph BC6.12).

clarifications below[6]. Then, by virtue of its design, grandfathering would imply that 'macro cash flow hedge accounting' was *inconsistent* with the new hedge accounting model, which in turn would raise the question how it was consistent with IAS 39[7], in particular given that IGs do not override the requirements of a standard but rather are just an illustration of their application and consequently cannot justify a departure from those.[8]

Clarifications

'Proxy hedging'

7. As noted above, some were concerned that 'proxy hedging' is not possible under the new hedge accounting model. As outlined below, the staff confirm that it is possible to apply 'proxy hedging'.

8. Notwithstanding the objective of the project "to represent, in the financial statements, the effect of an entity's risk management activities" this will still in many situations not be possible as a *simple, exact '1:1 copy'* of the actual risk management perspective. This is already obvious from some aspects of the new hedge accounting model, for example:

   (a) Net position cash flow hedges: the mere fact that this type of hedge is limited to FX risk[9] means that for all other types of hedge risk entities must use a 'gross designation'. The limitation does not mean that hedge accounting is prohibited for all other risks that are managed on a net position basis.

   (b) Risk components: an entity that actually hedges on a risk component basis but does not meet the criteria for designating the hedged item as a risk component[10] is not prohibited from applying hedge

---

[6] See section "Clarifications".

[7] The scenario that 'macro cash flow hedge accounting' was consistent with IAS39 but inconsistent with the new hedge accounting model would only be plausible if it was no longer possible as an application of the new hedge accounting model (in which case *clarifications* could *not* address the issue).

[8] See IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraph 9 in conjunction with paragraphs 7 and 12.

[9] See draft IFRS 9.6.6.1(c)(i).

[10] See draft IFRS 9.6.3.7(a).

accounting altogether. Instead, it is only prohibited from using the particular designation of a risk component. Consequently, the entity can designate the item in its entirety as the hedged item and apply hedge accounting if it meets all qualifying criteria[11].

(c) Hedge effectiveness: for many entities the actual risk management is based on a 'flow perspective'[12] for cash flow hedges, which only considers mismatches in the variable cash flows of the hedging instrument and the hedged item as a source of hedge ineffectiveness. However, the hedge effectiveness measurement for hedge accounting purposes does not allow assuming perfect hedge effectiveness in those circumstances (or limiting the analysis to only the variable cash flows of the hedging instrument). This does not mean that hedge accounting is prohibited but instead that the entity has to measure hedge ineffectiveness as required for accounting purposes.

(d) Presentation requirements for hedges of net positions: the new hedge accounting model requires using a separate line item in the income statement instead of directly adjusting the line items affected by the hedged items (eg grossing up revenue and costs of sales)[13] whereas the actual risk management typically considers the respective line items as hedged at the respective rates that were locked in by the hedges. This difference in views does not mean an entity was prohibited from using hedge accounting. Instead, it means the entity has to follow the presentation requirements for accounting purposes if it wants to apply hedge accounting.

9. *Unless* a 'hedge accounting model' simply adopted the risk management view *without any own accounting requirements*, designations of hedging relationships that constitute 'proxy hedging' are inevitable. Consequently,

---

[11] Not being able to designate a risk component as the hedged item has an effect on the hedge effectiveness assessment, which becomes more difficult and might sometimes become impossible to meet, but it does not constitute a prohibition of hedge accounting as such.

[12] See staff paper 4A2 of this meeting for an explanation.

[13] See draft IFRS 9.6.6.4.

the designations for hedge accounting purposes do *not* have to be *the same* as the actual risk management view.

10. However, designations must be *directionally consistent* with the actual risk management view. This is shown in that:

    (a) The qualifying criteria for hedge accounting, which require documenting "the entity's risk management objective and strategy for undertaking the hedge."[14] If the designation for hedge accounting purposes was not at least directionally consistent with the entity's risk management objective and strategy, then the entity's 'documentation' would be a misrepresentation of the facts instead of their description.

    (b) The disclosure requirements of the new hedge accounting model. Those disclosures connect information about the entity's risk management strategy with aspects of hedge accounting.[15] If the designation for hedge accounting purposes was not at least directionally consistent with the entity's risk management objective and strategy, the actual reaction of the entity's risk management to changes in circumstances and the resulting effect on the financial statements would entail the risk of contradicting the presentation of information in previous disclosures. In other words, a contradiction between what is actually being done and what was disclosed would eventually become apparent.

11. In that sense, documentation and disclosures create a natural boundary for designations such that they must be (at least) directionally consistent with actual risk management.

Discontinuation of hedge accounting

12. As noted above, some raised concerns that the draft requirements impose an 'all-or-nothing' approach to discontinuation of hedge accounting. The

---

[14] Draft IFRS 9.6.4.1(b).

[15] See for example the requirements in IFRS 7 *Financial Instruments: Disclosures* (as amended by draft IFRS 9), paragraphs 21A, 22A and 22B.

following section explains why this is an incorrect reading of the draft requirements.

13. The example in paragraph B6.5.24(b) says [emphasis added]:

> [...] After a short period of time, the entity discontinues previously designated hedging relationships for time buckets and designates new hedging relationships for time buckets on the basis of their size and the hedging instruments that exist at that time. Hedge accounting must be discontinued, because those hedging relationships are established in such a way that the entity looks at a new hedging instrument and a new hedged item instead of the hedging instrument and the hedged item that were designated previously. The risk management strategy remains the same, but there is no risk management objective that continues for those previously designated hedging relationships, which as such no longer exist.

14. The example—intentionally—leaves it open whether the hedging relationships that are discontinued are *all or some* of those previously designated for the respective time bucket. Either might be the case, ie one entity might routinely completely reset all of the hedging relationships whereas another entity only resets some (akin to an incremental approach).

15. In addition, paragraph B6.5.24(b) is *explicitly* introduced as an *example*. Therefore, *even if* the example illustrated only the most extreme case of resetting all hedging relationships the concern of some commentators that the paragraph suggested the discontinuation of hedge accounting applied on an 'all-or-nothing' basis to all hedging relationships under the dynamic risk management strategy would still be unwarranted. An example illustrating that the most extreme end of the range of possibilities results in discontinuation of all hedging relationships is *not a basis* for a 'reverse conclusion' that in all other situations an entity would also have to discontinue all of its hedging relationships.

16. In particular, the fact that the new hedge accounting model links the discontinuation of hedge accounting to the hedging relationship no longer

meeting the risk management objective means that there is no 'all-or-nothing' approach whereby entire hedging relationships for which the risk management strategy and objective have not changed would have to be discontinued as a result of the discontinuation of another hedging relationship for which the original risk management objective no longer applied. In fact, this would be explicitly precluded by paragraph B6.5.23:

> An entity shall not de-designate and thereby discontinue a hedging relationship that:
>
> (a) still meets the risk management objective on the basis of which it qualified for hedge accounting (ie the entity still pursues that risk management objective); and
>
> (b) continues to meet all other qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable).

17. In addition, the new hedge accounting model introduces the notion of partial discontinuation of hedge accounting (ie for only part of a hedging relationship) whereas under IAS 39 discontinuation affects the hedging relationship as a whole.[16] Introducing partial discontinuation as a more targeted, differentiating approach would not make sense if the same model required an 'all-or-nothing' approach.

Not carrying forward Implementation Guidance on hedge accounting

18. The new hedge accounting model is not accompanied by any IGs. The Board tentatively decided to use as the only guidance that accompanies the hedge accounting requirements some illustrative examples for the mechanics of accounting for designations of aggregated exposures as hedged items. Consequently, none of the hedge accounting related IGs that accompanied IAS 39 are carried forward.

19. This has resulted in a concern from some that this implies that the Board has sought to prohibit 'macro cash flow hedge accounting' in the new hedge accounting model.

[16] See draft IFRS 9.6.5.6, B6.5.25 and BC6.216.

20. The background of not carrying over the hedge accounting related IGs that accompanied IAS 39 was that:

    (a) those IGs are widely perceived as a particular example of rules-based standard setting, which is inconsistent with a move to a more principle-based approach to hedge accounting; and

    (b) selectively carrying forward some of those IGs but not others would create problems for all those IGs not carried forward because a *selective* approach would inevitably create the impression of being *prejudicial*.

21. In addition, if the issue is a concern over whether an accounting practice complies with the hedge accounting requirements then carrying forward (or developing new) IGs could *not* address this issue. This is because IGs only accompany but are not part of the standard, which means they do not override the requirements of a standard.[17] So if there was a conflict between an accounting practice and the requirements of a standard it could not be resolved by an IG that 'endorsed' that practice.

22. Consequently, the drafting without carrying forward the hedge accounting related IGs was intended. In particular, not carrying forward any hedge accounting related IGs best demonstrates that doing so is 'without prejudice', ie it does *not* imply that entities cannot apply cash flow hedge accounting in a 'macro' context (eg using gross designation) but it is also not a 'rubber stamp' of practice that would create the impression of exempting entities from compliance with new hedge accounting model.

Extent to which IAS 39 applies if scope exception is used

23. The scope exception for 'macro fair value hedge accounting' is set out in paragraph 6.1.3 of the draft [emphasis added]:

> For a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only for such a hedge), an entity may apply <u>the hedge accounting requirements in IAS 39 instead of those in this</u>

[17] See paragraph 6.

IFRS. In that case, the entity must also apply the specific requirements for fair value hedge accounting for a portfolio hedge of interest rate risk and designate as the hedged item a portion that is a currency amount (see paragraphs 81A, 89A and AG114–AG132 of IAS 39).

24. This is reinforced in the paragraph in IAS 39 that introduces the hedge accounting section (that remains) in that standard [emphasis added]:[18]

> If an entity applies IFRS 9 (as issued in [Date] 2012) it shall apply the hedge accounting requirements in chapter 6 of IFRS 9. However, for a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities, an entity may, in accordance with paragraph 6.1.3 of IFRS 9, apply the hedge accounting requirements in this standard instead of those in IFRS 9. In that case the entity must also apply the specific requirements for fair value hedge accounting for a portfolio hedge of interest rate risk (see paragraphs 81A, 89A and AG114-AG132).

25. Consequently, the staff consider that the draft *is clear* that an entity that uses the scope exception for 'macro fair value hedge accounting' applies all (applicable) hedge accounting requirements in IAS 39 and not only paragraphs 81A, 89A and AG114-AG132.

26. In addition to the drafting, this outcome is also apparent because if only paragraphs 81A, 89A and AG114-AG132 of IAS 39 (but not the other hedge accounting paragraphs) applied, they would have to apply in conjunction with the new hedge accounting model (to cover the aspects that are in those other paragraphs of IAS 39, eg regarding the effectiveness assessment). That would have required adapting paragraphs 81A, 89A and AG114-AG132 for language and cross-references, which is not the case.

[18] IAS 39.71 (as amended by draft IFRS 9). Therefore, the reference to "the hedge accounting requirements in this standard" will be clear because IAS 39 will not only retain paragraphs 81A, 89A and AG114-AG132 but the entire section like the current version of IAS 39, ie including the 80-125% range hedge effectiveness requirement etc.

Staff recommendations and questions to the Board

Grandfathering

27. For the reasons set out in the staff analysis, the staff consider that *grandfathering* 'macro cash flow hedge accounting', in particular by carrying forward the respective IGs of IAS 39 would be inappropriate because:

    (a) the scope of the draft is as it was intended, in particular the model design requires cash flow hedges to transition to the new hedge accounting model (instead of continuing to apply IAS 39);

    (b) it would create the danger of an unintended consequence;

    (c) carrying forward the IGs could not even achieve the objective of 'grandfathering' (given they do not override the requirements of a standard).

28. Consequently, the staff recommend retaining the requirements as drafted (ie *not* introduce grandfathering—cash flow hedges in a 'macro' context will need to be accounted for under IFRS 9).

Question 1: grandfathering
Does the Board agree with the staff recommendation to retain the requirements as drafted (ie *not* introduce grandfathering)? If the Board does not agree, how would it technically want to achieve grandfathering?

Clarifications

'Proxy hedging'

29. The staff analysis demonstrates that:

    (a) designations of hedging relationships that constitute 'proxy hedging' are inevitable; consequently, the designations for hedge accounting purposes do not have to be the same as the actual risk management view; *but*

(b) designations must be *directionally consistent* with the actual risk management view.

30. The staff consider that while this can be derived using an appropriate analysis of the new hedge accounting model, the concerns of some commentators that it was not clear enough whether ‘proxy hedging’ is allowed under the new hedge accounting model could be addressed by an explicit mentioning in the Basis for Conclusions (along the lines of the previous paragraph).[19] A clarification in the Basis for Conclusions was also suggested by some of the feedback.

31. The staff recommend including such a clarification in the Basis for Conclusions.

Question 2: ‘proxy hedging’
Does the Board agree with the staff recommendation to include a clarification in the Basis for Conclusions regarding ‘proxy hedging’ (that is directionally consistent with actual risk management—see paragraph 29)? If the Board does not agree, what does it want to do instead (if anything)?

Discontinuation of hedge accounting

32. The staff analysis demonstrates that the new hedge accounting model does not require an ‘all-or-nothing’ approach to discontinuation whereby entire hedging relationships for which the risk management strategy and objective have not changed would have to be discontinued as a result of the discontinuation of another hedging relationship for which the original risk management objective no longer applied.

33. However, it would be easy to revise the drafting of paragraph B5.6.24(b) to state that discontinuation applies to the extent to which the risk management objective changes, which could affect all or some hedging relationships (or a part of one)—depending on the situation of the entity.

[19] The staff will also consider some drafting adjustments for this aspect but have limited this paper to the substantive decisions required of the board instead of illustrating particular possible drafting changes.

Question 3: discontinuation (drafting of paragraph B5.6.24(b))
Does the Board want to revise the drafting of paragraph B5.6.24(b) to state that discontinuation applies to the extent to which the risk management objective changes? If not, what does the Board want to do instead (if anything)?

Not carrying forward Implementation Guidance on hedge accounting

34. For the reasons set out in the staff analysis, the staff consider that carrying forward the IGs related to 'macro cash flow hedge accounting' would be *inappropriate*, and not even achieve the objective of doing so.

35. However, the staff consider that the concerns of commentators that not carrying forward those IGs might create the impression of their rejection by the Board could be addressed by adding an explicit statement to the Basis for Conclusions that not carrying forward any hedge accounting related IGs was 'without prejudice'. An explicit clarification that not carrying forward the hedge accounting related IGs was 'without prejudice' was also suggested as a possible solution by some of the feedback. For those reasons the staff recommend this solution.

Question 4: clarifying that not carrying forward IGs is 'without prejudice'
Does the Board agree with the staff recommendation to add an explicit statement to the Basis for Conclusions that not carrying forward any hedge accounting related IGs was 'without prejudice'? If the Board does not agree, what does it want to do instead (if anything)?

Extent to which IAS 39 applies if scope exception is used

36. For the reasons set out in the staff analysis, the staff consider that the draft *is clear* that an entity that uses the scope exception for 'macro fair value hedge accounting' applies all (applicable) hedge accounting requirements in IAS 39 and not only paragraphs 81A, 89A and AG114-AG132.

37. Consequently, the staff do not consider any drafting changes are necessary.

Question 5: extent to which IAS 39 applies if scope exception is used

Does the Board agree with *retaining the* drafting regarding what requirements apply if an entity uses the scope exception for 'macro fair value hedge accounting' (ie *not* to make drafting changes)?

If not, what drafting change does the Board wish to make?