

## Hedge Accounting

### The ABI's Response to IASB Exposure Draft ED/2010/13

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#### Introduction

1. The ABI is the voice of insurance, representing the general insurance, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.
2. The ABI is grateful for the opportunity to respond to the IASB's December 2010 exposure draft of its hedge accounting proposals as part of the project to replace its existing standard, IAS 39 *Financial Instruments: Recognition and Measurement*.

#### General comments

3. IAS 39 has legitimately been criticised as limiting the ability of companies to faithfully report their performance and financial position. We welcome the efforts of the IASB to develop hedge accounting proposals that have the flexibility necessary to properly and fairly reflect the undertaking of economically rational hedging activity.
4. Hedge accounting is a legitimate requirement in so far as hedged items are either recorded on a cost basis or are not yet recognised while the chosen hedging instrument would normally be measured on a full fair value basis with gains and losses being taken in P&L as they are recognised. This fair value accounting might indeed be the only reasonable form of accounting for instruments when held on a 'naked' basis. However, where that instrument is instead held to hedge an item not recognised at fair value, a mismatch will inevitably occur.
5. We welcome the emphasis given in the Exposure Draft and the Basis of Conclusions to the fact that this is designed to apply principles-based accounting but it is disappointing that these principles are not as clearly articulated as they might be. We consider that the overarching rationale should be to achieve proper matching of profit and loss and of assets and liabilities. The impact of all hedging activity, whether effective or ineffective, should then impact profit and loss once its impact has flowed through. This means that it will often be right to make use of OCI for initial recognition of gains and losses on hedging instruments.
6. Alignment with business model concept as applied in the rest of financial instrument accounting is a helpful feature of the ED's proposals. It is vital that the impact of risk mitigation activity should drive the accounting rather than the accounting consequences of alternative strategies driving decisions as to what hedging activities, if any, to employ.

7. We agree with the abolition of the arbitrary 80/125 effectiveness test. We also agree with deletion of the backward facing effectiveness test. Provided that the impact of hedging ineffectiveness is recognised promptly in P&L we see no useful purpose from applying an ex post safeguard of this type.
8. We are mindful, nevertheless, of the risks of too much flexibility giving scope for accounting arbitrage. We have particularly noted the alternative views recorded from IASB board member, John Smith. We have not been able to judge how significant the risks are and it would have helped if the Board could have provided much more extensive worked examples of the impact of its proposals.
9. The use of options to achieve asymmetric hedging of adverse price movements whilst retaining the upside from favourable price changes is a legitimate risk mitigation strategy but it creates significant challenges regarding the appropriate accounting. We comment at greater length in the specific consultation question and we note that significant thought has been given by the Board and staff to a difficult subject. However we would observe that the proposed approach is complex and theoretical without being entirely soundly based. We propose a simpler approach that focuses on the real diminution in the value of the purchased option and avoids incoherent treatment of hedging via options relative to the alternatives.
10. We await the proposals of the Board on macro-hedging and open portfolios. Appropriate accounting solutions here are important and without progress in this regard it is difficult to draw clear conclusions regarding the whole project.

## Questions for Consultation

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### Question 1

**Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?**

It is helpful to have this stated objective for hedge accounting though we note the somewhat limited scope relating only to risks that affect profit or loss. From investors' perspective the overarching objective is to ensure that the accounting reflects the economics of the business activities and the risk mitigation strategies that are employed.

### Question 2

**Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?**

Yes we agree that these should be eligible hedging instruments.

### Question 3

**Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?**

Yes, we agree as this could well reflect a legitimate hedging strategy.

### Question 4

**Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (i.e. a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?**

Yes we think this is appropriate as the hedging of components of an overall risk will often be the reason why an entity will wish to hedge.

We note that the ED will not permit inflation be designated as a risk component of a financial instrument unless it is contractually specified on the grounds (as per Paragraph B18 of the ED) that inflation is not separately identifiable and reliably measurable. Given that hedging of inflation risk is, and is likely to remain, a widespread objective we think that efforts should be made to provide a basis for this to be eligible for hedge accounting. To the extent that there are technical challenges in this area they will be relevant whether or not inflation is contractually specified in the hedged item and we do not think therefore that this should be relevant to eligibility. In addition, it is not clear to us why paragraph B18 of the ED only applies to financial instruments, but not to non-financial instruments. We believe that the IASB should develop a stronger conceptual basis for deciding which non-contractual inflation components may be designated as hedged items.

#### **Question 5**

**(a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?**

**(b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?**

We agree with the eligibility of a layer of the nominal amount of an item as the hedged item as this could constitute a valid hedging strategy. If a prepayment option changes the nature of the hedged risk the accounting needs to reflect this and therefore restrictions on eligibility could be necessary.

#### **Question 6**

**Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?**

We agree with the proposed removal of the arbitrary 80/125 per cent expected effectiveness test and with the deletion of the retrospective effectiveness test. The key requirement should be for all hedge ineffectiveness, expected or unexpected, to be reflected in the primary statements as it arises.

#### **Question 7**

**(a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?**

**(b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?**

Where the effectiveness of the hedging relationship changes the accounting needs to change to reflect this, consistent with the need for hedge ineffectiveness to be recognised as it arises. It is logical for an entity to seek to rebalance the hedge in the light of evidence that its strategy over- or under-compensates for changes in the hedged item but in practice it may choose not to rebalance fully or at all. The accounting needs to reflect this. Logically this means that a decision not to rebalance would lead to a recognition of excess movements on the hedging instruments in P&L as appropriate and under-effectiveness as a reduction in the proportion of the nominally hedged item as subject to the hedge.

#### **Question 8**

**(a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?**

**(b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?**

Yes, we believe in principle that hedge accounting should be voluntary but that once invoked, and so long as the hedged item and hedging instrument are held, which together constitute a strong *prima facie* indication that the hedging strategy remains in place, the hedge accounting should continue.

However, as formulated, the proposed 'rule' might lead to outcomes that do not accord with this principle. For example, a hedging relationship might remain in existence but the accounting for the hedged item be changed once a transaction is booked. Terminating the hedge accounting at this point would actually be necessary in order to ensure continued aligned treatment of the subject of the hedge and the hedging instrument.

#### **Question 9**

**(a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?**

**(b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?**

**(c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?**

We agree with the recognition of hedging gains and losses in OCI and the proposed line item presentation in the statement of financial position. This would facilitate user understanding of the position of the issuer where the balance sheet numbers both before and after the effects of hedge accounting are of obvious interest.

#### **Question 10**

**(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (e.g. like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?**

**(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?**

**(c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (i.e. the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?**

The proposed accounting involving potentially different treatment of intrinsic value and time value is complex. Although conceptually distinct, demarcation of the two for accounting purposes over the life of a hedge is of questionable appropriateness given the continuous changes that take place over the option life. Time value will have a tendency to change into intrinsic value over the duration but there is also the possibility of movement in the opposite direction over shorter periods during the option life.

We are unconvinced by either of the two suggested ways of conceptualising the option premium (or part of it) at the outset viz as either an element of a transaction cost or else as a payment analogous to an insurance premium. It is not evident that the value of the underlying item being hedged should be thought in any way to depend upon the whether a decision is taken to hedge it, not to hedge it or to take out an option to hedge one side of the risk.

The use of options for risk mitigation is not a genuine outright hedge or, alternatively, it might reasonably be regarded as a compound strategy of a hedge together with a right to renege on this hedge if it is economically advantageous to do so. From that perspective, the time value at the outset inherent in the option premium is simply the cost of securing this latter benefit. To fair value this element of the option value would typically lead, however, to the counter-intuitive recognition, on the one hand, of a gain as each of the hedged item and the value of the option decline (because the first will tend to decline faster than the second) and, on the other hand, a loss as they each correspondingly increase. (If the option strategy is compared to a fully symmetric hedge a theoretical net cost or benefit can be estimated as the option life reduces and changes take place in original parameters of price and volatility of the underlying.) By contrast, simply to write off the price, or a part of the price, of the option value at the outset fails to allow for any matching gain which will typically accrue and with an average or expected value similar to the original option cost.

A better way of considering option use for hedging purposes would be to consider the emerging pay-offs of this strategy versus the other available strategies of symmetric hedging and not hedging. There are some scenarios in which the use of the option will produce an inferior result to one but superior to the other and it is anomalous, we feel, to expect a P&L gain or charge in such circumstances. There are no scenarios over the life of the option in which the option-related strategy will give a better result than both symmetric hedging at the outset or no hedging being employed.

However, there are some scenarios under which the option strategy will be worse than both full hedging and no hedging. It is this specific outcome, or rather, the emerging (or diminishing) likelihood that this will be the outcome that represents an unambiguous impairment (or enhancement) in option value that ought to be provided for in P&L while the option is held, and which would crystallise if the entity chose (which it might quite rationally do, for example in order to put in a fully symmetric hedge) to sell the option. If this element of P&L accounting is allowed for there is then a strong case for taking residual gains and losses to OCI with these changes then flowing through into P&L as all components of the hedge and related transactions crystallise.

**Question 11**

**Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?**

This is a complex area that poses significant challenges for accounting as well as the nature of corporate risk management though in principle we would wish sensible hedging strategies to be facilitated.

**Question 12**

**Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (e.g. in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?**

We agree that a full measure of disclosure is necessary in this case to allow a proper understanding but we are concerned that the proliferation of line item presentation may be excessive.

**Question 13**

**(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?**

**(b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?**

It is important to get the balance right. Hedge accounting will lead to greater mandatory disclosure of information than if this is not elected. It is not in investors' interests that companies are dissuaded from so electing where it is otherwise appropriate because of the compliance burden, or because it would require the disclosure of information considered commercially confidential by the entity.

**Question 14**

**Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?**

Yes, we do not consider that the cash settlement of the derivatives held as a hedging instrument should be a constraint on eligibility for accounting that reflects the underlying economics and business model.

**Question 15**

**(a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?**

**(b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?**

It is evident that the use of credit derivatives for managing credit risks poses significant challenges in the accounting. Further work is needed in achieving a workable regime that will avoid excess volatility and also command the confidence of users.

**Question 16**

**Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?**

It is important that an undue compliance burden on preparers is avoided and this argues for both a sufficiently long planning and transition period and also flexibility as to treatment of existing hedging transactions at the time that the new standard is introduced.

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