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| Project | Financial Instruments: Hedge Accounting |
| Topic | Foreign exchange—‘funding swaps’ |

Introduction

Background

1. We learnt during the course of the IASB’s extensive outreach activities on the exposure draft *Hedge Accounting* (ED) that financial institutions in Asia often use ‘funding swaps’ to manage their exposures to foreign exchange rate risk arising from borrowing in one currency and lending in another.
2. Common feedback from comment letters and outreach activities was that the accounting for ‘funding swaps’ under IAS 39 *Financial Instruments: Recognition and Measurement* gives rise to profit or loss volatility and presentation (ie how income statement line items are affected) that are not reflective of the economics of the transaction. Hence, the feedback was that financial statements under IFRSs fail to reflect the economic substance of these transactions and do not provide useful information to users of financial statements.

Purpose

3. The purpose of this paper is to:
 - (a) provide a description of how funding swaps are used to manage foreign exchange rate risk; and
 - (b) provide an analysis of the accounting implications under IFRSs; and

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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- (c) set out the next steps.
4. **This paper is for educational purposes. It does not ask the Board for a decision.** The Board will discuss alternatives at a future meeting.

Funding swaps

5. In Asia, financial institutions often have more funding in their local currency (for example from their strong customer deposit basis) than they can invest in financial assets (eg loans, commercial paper, and money market products etc) in their domestic currency. To generate an economic return on their surplus funds, many Asian financial institutions exchange these funds into a foreign currency (usually US dollars and euros) and invest in assets denominated in that foreign currency.
6. In order to protect the investments against foreign exchange (FX) risk and to stabilise the net interest margin in such a scenario, the banks typically enter into FX derivatives (eg currency swaps or forwards). These hedging derivatives are commonly referred as ‘funding swaps’.
7. A funding swap transaction usually simultaneously involves the following:
- (a) swap the local currency surplus funds into foreign currency, eg US dollars or euros at the spot rate; and
 - (b) invest the funds into the foreign currency-denominated financial assets for a period of time; and
 - (c) enter into an FX derivative to convert the foreign currency funds back into the local currency at the end of the investment period. This amount typically covers the principal plus interest at maturity.
8. The difference between the forward rate and the spot rate (ie forward points) represents the interest differential between the two currencies at inception. The net economic return (ie the interest margin) over the investment period is determined by adjusting the yield of the investment in the foreign currency for

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the forward points (of the FX derivative) and then deducting the interest expense. (The FX gains and losses from the investment are offset by the FX gains and losses of the FX derivative from changes for the spot rate.) The combination of the three transactions described above in effect allows the financial institution to ‘lock in’ a net interest margin and generate a fixed economic return over the investment period.

Staff analysis of the issue

9. This section of the paper analyses accounting implications of the FX funding swap transaction under IFRSs and under the ED.
10. The following table sets out the measurement of the different items in a funding swap transaction in the balance sheet:

| | Balance sheet |
|---|-------------------------------------|
| Investment in foreign currency | At spot FX rate (IAS 21) |
| Interest revenue in foreign currency | At spot FX rate (IAS 21 and IFRS 9) |
| FX forward contract | At fair value (IFRS 9) |
| Borrowings (eg customer deposits) in local currency | At amortised cost (IFRS9) |

11. At the end of the investment period the following elements generate a fixed net interest margin or net economic return of the funding swap transaction:
 - (a) the gain or loss on the foreign investment from the change in the spot FX rate;
 - (b) the accrued interest revenue at the end of the period (including the related FX gain/loss);
 - (c) the gain or loss from the fair value changes of the FX derivative; and
 - (d) the accrued interest expense.
12. Under hedge accounting today and the ED, entities can designate the spot element of the forward contract and leave the change in the forward points

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undesigned. The gain or loss from the changes in the forward points is presented like a trading gain or loss. This is not consistent with how the forward points are perceived economically, ie risk management views the forward points as part of interest revenue in the context of the funding swap transaction. This is similar to the issue that the Board addressed for options used as hedging instruments.

Next steps

13. During the outreach and in the comment letters, financial institutions in Asia have suggested that the Board consider extending the treatment proposed in the ED for the accounting for the time value of options to forward points. The ED proposes a change in the accounting for time value of options to better reflect risk management's view that the time value of an option is a cost of hedging—cost of obtaining protection against unfavourable changes of prices, while retaining participation in any favourable changes. These financial institutions argue that in a funding swap transaction risk management views the forward points as an adjustment of the investment yield in the foreign currency. In their view, this gives rise to a similar need for adjusting profit or loss against OCI as in the case of the time value of options regarding the cost of achieving a fixed economic return.
14. Many outreach participants and respondents from other parts of the world also think that the proposals for accounting for the time value of option should be extended to forward points for the reasons outlined above.

The staff intend to discuss with the Board the possible alternatives at a future meeting where a part of the fair value changes of the FX derivative is recognised in other comprehensive income (OCI) and reclassified to profit or loss in a manner that reflects the economics of such transactions.