Project	**Financial Instruments (Replacement of IAS 39)—Hedge Accounting**
Topic	**Rebalancing (adjustments to the hedge ratio)**

Introduction

Background

1. This paper addresses the feedback received on the proposals in the exposure draft *Hedge Accounting* (ED) regarding rebalancing (question 7 in the invitation to comment).
2. The paper contains one question to the Board.
3. This paper does not cover voluntary discontinuation (this covered in agenda paper 9).
4. This paper also does not cover rebalancing in the context of macro hedge accounting, which will be discussed separately by the Board.

Overview of the proposals in the ED[1]

5. The ED proposes changes to the discontinuation provisions for hedge accounting. As part of the ED the Board introduced the notion of rebalancing, which means entities adjust a hedging relationship in order to change the hedge ratio *without* discontinuing hedge accounting.
6. The ED includes two situations for rebalancing:
    (a) mandatory rebalancing; and

[1] Refer to paragraphs B46 to B60 of the ED and agenda papers series 17 at the 18 October 2010 IASB meeting.

(b) proactive (ie voluntary) rebalancing.

7. Rebalancing is *required* if the risk management objective has not changed but the hedging relationship would otherwise (ie without the adjustment) fail the effectiveness assessment.

8. Rebalancing is *permitted* when an entity expects that on the basis of the current hedge ratio a hedging relationship might cease to meet the effectiveness assessment in the future.

9. Rebalancing results in reductions or increases in the quantities of the hedging instrument or hedged item designated as part of the hedging relationship in order to maintain an appropriate hedge ratio.

Rationale for the proposals

10. Rebalancing has been proposed for two reasons:

    (a) in response to concerns about the outcomes of the hedge accounting model in IAS 39 *Financial Instruments: Recognition and Measurement*; and

    (b) to complement the hedge effectiveness assessment proposed in the ED.

Concerns about the outcomes of the hedge accounting model in IAS 39

11. IAS 39 does not allow adjustments that were not envisaged (documented) at the inception of the hedge[2] to be treated as adjustments to an existing (ie *continuing*) hedging relationship. Instead, such adjustments are treated as a discontinuation of the original hedging relationship and the start of a new one *even if* the risk management objective remains the same (and hence the entity continues that hedge for risk management purposes). This results from a hedge accounting model that does not include the notion of accounting for changes to an existing hedging relationship as a continuation of that relationship.

12. Hence, if an entity wants to retain hedge accounting for such a hedge it can only choose to (re-)start the hedging relationship as a new one that includes the

[2] For example rollovers of hedging instruments are accepted as part of a continuing hedging relationship if they are part of an entity's documented hedging strategy, see IAS 39.91(a) and 101(a).

adjustments. A hedging relationship that needs frequent adjustments is therefore discontinued many times over the time of the hedge.

13. This accounting raises concerns in instances where, although the risk management objective remains the same, there are adjustments to an existing hedging relationship because of changes in circumstances. For example, these adjustments are often required to re-align the hedging relationship with risk management in view of changed circumstances (eg if a hedging relationship experiences increasing hedge ineffectiveness that could result in falling outside of the 80 to 125 per cent range). Such adjustments to the hedged item or hedging instrument do not change the original risk management objective but instead reflect a change in how hedging is executed owing to the changes in circumstances.

14. In such situations rebalancing would provide a better link between accounting and risk management because it allows the continuing (economic) hedge to be portrayed for accounting purposes as a continuing hedging relationship (instead of a combination of a new hedging relationship and discontinued ones). This avoids treating the hedged item on every restart of a new hedging relationship as if it had not been hedged before. Otherwise hedge accounting would not accurately portray the hedge, which was used to manage the exposure from the start of the original (ie the first) hedging relationship.

Complement of the hedge effectiveness assessment

15. The second reason for introducing the notion of rebalancing were the ramifications of the ED's new hedge effectiveness assessment, which proposed that a hedging relationship has to be designated in such a way that it will produce an unbiased result and minimise expected hedge ineffectiveness. For some changes in circumstances that affect a hedging relationship's hedge ratio this new hedge effectiveness assessment would create the need for an adjustment to the hedging relationship in order to ensure that the hedge effectiveness requirements would continue to be met. An example is a change in basis risk that changes the relationship between two economically related variables (or 'underlyings'—one affecting the hedged item and one the hedging instrument) in such a way that the hedge ratio would need to be adjusted in order to avoid the hedging relationship producing a biased result (which would arise when using the original hedge ratio in the new circumstances).

16. In such situations, if the original risk management objective remains unaltered; rebalancing would treat the adjustment to the hedging relationship as the *continuation* of the hedging relationship.

17. *Proactive* use of rebalancing would allow an entity to adjust hedging relationships on a timely basis and at the same time would strengthen the link between hedge accounting and risk management.

18. Hence, the ED proposed to permit proactive rebalancing that aims to ensure that the hedging relationship will continue to qualify for hedge accounting (ie the adjustment aims at reducing the likelihood of failing the hedge effectiveness assessment). Such a proactive adjustment would be consistent with the objective of the hedge effectiveness assessment, which is to ensure that a hedging relationship reflects an appropriate hedge ratio.

Feedback from comment letters and outreach activities

19. The responses in the comment letters and feedback from the outreach activities showed that there is strong support for introducing the notion of rebalancing in the hedge accounting model. The majority of respondents either agree or conditionally agree with the proposals that facilitate rebalancing of a hedging relationship. They agree that the hedge accounting model should include a notion whereby a hedging relationship can be adjusted and accounted for as the continuation of that existing hedging relationship. Respondents also thought that the inclusion of this concept would enhance the application of hedge accounting and would be a better representation of what entities do as part of their risk management activities. Feedback received during the outreach activities was consistent with the feedback received in the comment letters.

20. Some of those respondents who agreed with the rebalancing proposals asked the Board to specify clearly the circumstances when rebalancing is required or permitted. This was driven by the uncertainty that respondents had as to whether rebalancing has only been designed to deal with adjustments to the hedge ratio in the context of the objective-based effectiveness assessment or whether it also relates to the adjustments of hedged volumes when the hedge ratio is still appropriate (ie when an entity wants to hedge more or less than originally).

21. Some commentators who agreed with the proposals asked the Board to clarify whether the addition or removal of hedged items to or from a portfolio of hedged items would be, in substance, rebalancing or whether that would instead trigger a discontinuation of hedge accounting. They were also interested in the interaction of the rebalancing provisions with macro hedge accounting.

22. Some of the respondents who conditionally agreed argued that the proposals for rebalancing were welcome, but that they would be difficult to operationalise because of the lack of guidance. In their view, the following guidance would be needed to make the proposals operational:

    (a) guidance on what is the level of risk management that should be considered for the purpose of rebalancing (ie risk management *strategy* or risk management *objective* for the hedge designation). The issue of risk management strategy vs. risk management objective is addressed as part of agenda paper 9 on voluntary discontinuation of hedge accounting;

    (b) guidance on the relationship between rebalancing and changes to the hedged volumes. This was raised as some commentators were unclear whether rebalancing was intended to be used in a narrow way and only to adjust the hedging relationship in response to changes in the hedge ratio or conversely it was intended to be used in a wider way that would also encompass adding (removing) quantities of the hedged item and hedging instrument even if not in response to changes in the hedge ratio (see paragraph 20).

23. Some of the respondents who conditionally agreed also raised the issue that the rebalancing notion, despite being useful, is very judgemental and hence, the Board should provide more guidance on the notion of rebalancing. In addition, some of the respondents who conditionally agreed argued that rebalancing should be permitted and not mandatory, because risk management often chooses not to rebalance based on a mathematical *optimisation* exercise implied in the ED because doing so would not be cost-effective, or simply because the hedge is still within tolerance limits that an entity might use. There was concern that the current wording of the provisions implies that such a continuous optimisation exercise (with the aim of always having the ‘perfect’ hedge ratio) would be needed as a consequence of the interaction with the ‘unbiased’ requirement of the new objective-based effectiveness assessment (refer to agenda paper 1B

presented at the meeting on 12 May 2011 for an explanation of the meaning of 'unbiased result').

24. Almost all the respondents directly or indirectly asked the Board to clarify that rebalancing should only be required when done for risk management purposes, and that hedge accounting should follow to reflect the accounting consequences of such rebalancing (not trigger it—ie accounting should not drive risk management).

25. Few commentators disagreed with the proposals. Those who disagreed with the proposals did so for a variety of reasons, which are listed below.

    (a) Rebalancing should be optional. If this cannot be achieved then rebalancing is not an improvement.

    (b) Rebalancing is incompatible with, or difficult to understand for, a hedging relationship that is defined on a 1-to-1 hedge ratio and therefore this might be interpreted as if it precludes application of such a hedge ratio.

    (c) The mandatory rebalancing provisions show that the Board lacks confidence in risk management.

    (d) If the hedging relationship is no longer valid (based on any of the qualifying criteria) it should be discontinued.

    (e) There is a danger of entities transacting derivatives solely for the purpose of complying with the rebalancing provisions.

26. For proactive rebalancing (question 7(b) in the invitation to comment), there was overwhelming support for the possibility of proactively rebalancing the hedging relationship without discontinuation. Commentators felt that this represents a step towards further alignment of hedge accounting with risk management.

27. Very few commentators disagreed with the notion of proactive rebalancing. Those who did were concerned that consistent application of proactive rebalancing may not be achieved because entities can simply state that they want to adjust the hedging relationship without any further consideration. Some within this group thought that discontinuation that was based on a qualitative threshold such as 'reasonably effective' would give a better answer than the rebalancing provisions, because these provisions were complex and would involve significant costs. These respondents see rebalancing simply as a way to meet hedge accounting rules.

28. Finally, some respondents who disagreed thought that the concept of rebalancing is not needed and that entities can simply recognise hedge ineffectiveness without discontinuing the hedging relationship.

Staff analysis

The issues

29. The staff note that the comment letter and outreach feedback shows that there is strong support for the notion of rebalancing but that commentators did raise some issues. Hence, the staff consider that in order to finalise the proposals the Board needs to address the following main issues raised:

    (a) whether rebalancing should be mandatory or voluntary;

    (b) clarification of the term 'rebalancing'.

30. The staff note that the Board's tentative decisions on the hedge effectiveness assessment at the 12 May 2011 meeting (the 'tentative decisions')[3] changed some aspects of the hedge effectiveness assessment proposed in the ED. The staff consider that those changes are relevant for the redeliberations of the rebalancing proposals because rebalancing complements the hedge effectiveness assessment.[4] Hence, the staff analysis takes into account those tentative decisions (ie it is not based on the proposals as they were originally set out in the ED).

Mandatory or voluntary rebalancing

31. The question of whether rebalancing should be mandatory or voluntary relates to several different aspects of rebalancing that interact with the hedge effectiveness assessment:

    (a) the link between rebalancing and risk management;

---

[3] See Appendix A.
[4] See paragraph 10(b).

(b) the need for proactive[5] rebalancing; and

(c) the frequency of rebalancing.

32. In addition, this issue interacts with the proposals for the discontinuation of hedge accounting (see agenda paper 9).

Link between rebalancing and risk management

33. The tentative decisions on the effectiveness assessment mean (subject to confirmation of wording) that an entity's designation of the hedging relationship would be based on the quantity of hedged item that it actually hedges and the quantity of the hedging instrument that it actually uses to hedge that quantity of hedged item *provided that* this designation does not reflect an imbalance that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting.

34. The staff note that those tentative decisions were made to address concerns of respondents about the hedge effectiveness assessment proposals regarding the following elements:

(a) that the hedging relationship will produce an unbiased result;

(b) that the hedging relationship will minimise expected hedge ineffectiveness; and

(c) that the entity has no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item such that they would produce a biased result

35. The notion of rebalancing was introduced as a complement to the new hedge effectiveness assessment with regard to the requirements for a hedging relationship's hedge ratio (see section 'Complement of the hedge effectiveness assessment'). Hence, the staff consider that the Board's tentative decisions on the hedge effectiveness assessment also address those concerns about the rebalancing proposals that related to concerns about the hedge effectiveness assessment.

[5] See paragraph 8.

36. This would in the staff's view address the main concern about rebalancing, which is how rebalancing for hedge accounting purposes relates to rebalancing for risk management purposes. To be specific:

    (a) The Board's tentative decisions on the hedge effectiveness assessment mean that an entity *starts* the hedging relationship using the quantities of the hedged item and the hedging instrument that it actually uses *provided that* this designation does not reflect an imbalance that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting (ie it starts with an appropriate hedge ratio).

    (b) Consequently, rebalancing relates to adjustments to the quantities of the hedged item or the hedging instrument that would *maintain* compliance with these requirements of the hedge effectiveness assessment set out above for the remainder of the hedging relationship. In other words, rebalancing relates to maintaining an appropriate hedge ratio after the start of the hedging relationship over its remaining life.

37. This means that the hedge ratio used for risk management purposes is also used for hedge accounting *unless* this designation would reflect an imbalance that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting. Hence, after the start of a hedging relationship an entity would rebalance that hedging relationship for hedge accounting purposes when it adjusts the hedge ratio for risk management purposes. *However*, the hedging relationship for hedge accounting purposes would have to use a different hedge ratio than for risk management purposes if:

    (a) the adjustments for risk management purposes would result in a hedge ratio that would reflect an imbalance that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting; or

    (b) for risk management purposes an entity would retain a hedge ratio that in new circumstances would reflect an imbalance that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting (ie an entity must not create an imbalance by omitting to adjust the hedge ratio).

38. The staff consider that this interaction between rebalancing for hedge accounting purposes and rebalancing for risk management purposes would also address other concerns that were a consequence of the issues raised regarding the hedge effectiveness assessment:

    (a) when an entity would need to rebalance, including whether rebalancing requires a mathematical optimisation exercise;

    (b) the relevance and implications of tolerance limits used for risk management purposes, including how it relates to hedging relationships that are based on a 1-to-1 hedge ratio; and

    (c) in what circumstance rebalancing is required or permitted (or not allowed), including to what extent hedge accounting facilitates rebalancing done for risk management purposes.

Need for proactive rebalancing

39. The notion of *proactive* rebalancing was also introduced as a complement to the new hedge effectiveness assessment in order to allow an entity to adjust hedging relationships on a timely basis and at the same time strengthen the link between hedge accounting and risk management (see section 'Complement of the hedge effectiveness assessment').

40. The staff consider that the interaction between rebalancing for hedge accounting purposes and rebalancing for risk management purposes that results from the Board's tentative decisions on the hedge effectiveness assessment[6] would facilitate those adjustments to a hedging relationship that were addressed by the notion of proactive rebalancing in the ED. If for risk management purposes an entity adjusts the hedge ratio in response to changes in the economic relationship between the hedged item and the hedging instrument the hedging relationship for hedge accounting purposes would **automatically** be adjusted in the same way (provided that this reflects an appropriate hedge ratio[7]).

[6] See paragraphs 37-38.
[7] See paragraph 36.

41. Hence, the staff consider that retaining proactive rebalancing as a separate notion of the hedge effectiveness requirements is no longer necessary. Instead, the final requirements could be simplified by eliminating this separate notion.

The frequency of rebalancing

42. The frequency of *rebalancing* depends on two factors:

    (a) the frequency of hedge effectiveness *assessment*; and

    (b) how often the assessment results in a need to adjust the hedging relationship.

43. The ED requires that an entity assesses on an ongoing basis whether a hedging relationship meets the hedge effectiveness requirements. At a minimum the assessment is required at each reporting date or upon a significant change in circumstances affecting the hedge effectiveness requirements (whichever comes first).[8] This ensures that an entity does not, by omitting to adjust the hedge ratio cause an imbalance that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting.[9]

44. The concern was that this would result in a continuous rebalancing because the perception of a mathematical optimisation exercise would have required an adjustment of the hedge ratio on each assessment date and in addition the perception of a required optimisation raised concerns that assessments of the hedge ratio would have routinely been required during reporting periods because of minor changes in circumstances. The combined effect on the frequency of rebalancing was considered unsustainable.

45. In the discussions on the hedge effectiveness assessment, the related concern that the ED implied that the 'perfect' hedge ratio had to be established irrespective of all practical considerations was addressed. As a result, the staff consider that the interaction between rebalancing for hedge accounting purposes and rebalancing for risk management purposes that results from the Board's tentative decisions on the hedge effectiveness assessment[10] would address these

[8] See ED.B32.
[9] See paragraph 37(b).
[10] See paragraphs 37-38.

concerns because this clarifies that rebalancing is not a mathematical optimisation exercise disconnected from risk management.[11]

46. The staff consider that as a result of addressing the concerns about the frequency of rebalancing the concerns of some commentators about frequent partial discontinuations of hedging relationships would also be addressed. The concern of those commentators was that on each rebalancing a partial discontinuation of a hedging relationship can arise (ie when the quantity of the hedged item is reduced in order to adjust the hedge ratio), which gives rise to operational complexity.

Clarification of the term 'rebalancing'

47. Similarly to the feedback on other aspects of the proposed hedge effectiveness assessment[12], there was a request for more guidance on the notion of rebalancing. This request relates to how rebalancing relates to risk management (and hence to the instances where risk management rebalances the hedging relationship versus when it is required to be rebalanced for accounting purposes) and to the frequency of rebalancing. The latter led to the concern that rebalancing would be an optimisation exercise with no relationship with risk management.

48. The staff consider that requests to clarify how rebalancing relates to risk management, proactive rebalancing and the frequency of rebalancing are all addressed by the interaction between rebalancing for hedge accounting purposes and rebalancing for risk management purposes that results from the Board's tentative decisions on the hedge effectiveness assessment (see section 'Mandatory or voluntary rebalancing'). Those were the main requests for clarification that commentators raised.

49. Other requests for clarification relate to the *scope* of the term rebalancing. Those requests are about what adjustments to a hedging relationship constitute rebalancing and what adjustments are not part of rebalancing. Examples are requests for clarification regarding:

[11] See paragraph 38(a).
[12] Refer to agenda papers 1A and 1B discussed at the meeting on 12 May 2011.

(a) whether any addition or removal of hedged items to or from a portfolio of hedged items would be, in substance, rebalancing;

(b) the interaction between rebalancing and 'headroom'; and

(c) the interaction between rebalancing and risk components.

50. The staff consider that those questions reflect that some commentators have a *wider* notion of rebalancing in mind than that used in the ED. The ED used the notion of rebalancing in a narrow sense of adjusting the quantities of the hedging instrument or hedged item *in order to* maintain a hedge ratio that complies with the hedge effectiveness requirements. Changes to the quantities of the hedging instrument or the hedged item for a different purpose do not constitute 'rebalancing' as the term is used in the ED.

51. Even though the ED[13] specified that rebalancing was used in the narrow sense described above the Board could provide further clarification to the effect that rebalancing covers *only* adjustments for the purpose of maintaining a hedge ratio that complies with the hedge effectiveness requirements. The staff consider that would remove any remaining questions that some commentators had about the scope of rebalancing.

52. In addition, similarly to the feedback received on the hedge effectiveness requirements, the staff consider that some other issues raised simply reflect the fact that people are unfamiliar with the new requirements and are uncertain about exercising judgement resulting from moving from a bright-line test with no ability to adjust a hedging relationship for changes in circumstances to an assessment that involves judgement,[14] and that such concerns are inevitably associated with a major change. Hence, the staff do not consider changes can be made to address these issues but rather with familiarity these issues should reduce over time.

Arguments cited for disagreement with the rebalancing proposals

53. Similarly to the feedback received on the hedge effectiveness requirements, a few commentators disagreed because they favour a rules-based approach or the

[13] See ED.B47.
[14] See section 'Concerns about the outcomes of the hedge accounting model in IAS 39'.

discontinuation and restart of hedging relationships in combination with a threshold (similarly to IAS 39). This is fundamentally different from the direction of the hedge accounting project and an improved link with risk management and irreconcilable with the views of the other commenters as well as the Board's tentative decisions on the hedge effectiveness assessment at the 12 May 2011 meeting.

54. The staff consider that some of the concerns of those who disagreed because of the interaction between rebalancing for hedge accounting purposes and for risk management purposes would be addressed by the interaction between rebalancing for hedge accounting purposes and rebalancing for risk management purposes that results from the Board's tentative decisions on the hedge effectiveness assessment.[15]

Staff recommendations and question to the Board

55. The staff note that the notion of rebalancing was introduced as a complement to the new hedge effectiveness assessment with regard to the requirements for a hedging relationship's hedge ratio (see section 'Complement of the hedge effectiveness assessment'). Hence, the staff consider that the notion of rebalancing has to be aligned with the Board's tentative decisions on the hedge effectiveness assessment.

56. Therefore, the staff recommend consequential changes to the notion of rebalancing as it was proposed in the ED to *align* it with the Board's tentative decisions on the hedge effectiveness assessment. The main effect of these consequential changes would be:

    (a) After the start of a hedging relationship an entity would rebalance that hedging relationship for hedge accounting purposes when it adjusts the quantities of the hedging instrument or the hedged item in response to changes in circumstances that affect the hedge ratio of that hedging relationship (ie the 'hedge ratio is adjusted for risk management purposes'). *However*, the hedging relationship for hedge accounting

[15] See section 'Mandatory or voluntary rebalancing'.

purposes would have to use a different hedge ratio than for risk management purposes if:

(i) the adjustments for risk management purposes would result in a hedge ratio that would reflect an imbalance that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting; or

(ii) for risk management purposes an entity would retain a hedge ratio that in new circumstances would reflect an imbalance that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting (ie an entity must not create an imbalance by omitting to adjust the hedge ratio).[16]

(b) The notion of proactive rebalancing is eliminated (because it has become obsolete).

57. The staff also recommend clarifying that rebalancing covers *only* adjustments to the quantities of the hedged item or the hedging instrument *for the purpose of* maintaining a hedge ratio that complies with the requirements of the hedge effectiveness assessment.

58. The staff consider that these recommendations address the main concerns raised by respondents and ensure consistency between rebalancing and the Board's tentative decisions on the hedge effectiveness assessment.

Question—rebalancing
Does the Board agree with the staff recommendations in paragraphs 56 and 57?

[16] See paragraph 37.

If the Board disagrees with the staff recommendation, what would the Board prefer instead and why?

Appendix A

A1. Summary of the tentative decisions at the 12 May 2011 IASB meeting on hedge accounting (quote from IASB Update):

> At this meeting the IASB continued its redeliberations on the exposure draft (ED) *Hedge Accounting* and discussed the proposed hedge effectiveness assessment (to qualify for hedge accounting). The Board discussed:
>
> - clarification of the requirement of achieving 'other than accidental offsetting'; and
> - the meaning of the requirement that a hedging relationship should produce an 'unbiased' result and minimise expected hedge ineffectiveness.
>
> **Clarification of the term 'other than accidental offsetting'**
>
> Feedback from comment letters and from the outreach activities showed strong support for moving from a quantitative threshold-based assessment to a principle-based assessment. The feedback also highlighted a request for further guidance on the meaning of the term 'other than accidental offsetting'.
>
> The Board considered that the feedback showed that the use of umbrella terms such as 'other than accidental offsetting' that comprise several aspects was abstract, which made them difficult to understand.
>
> The Board noted that the criterion of 'other than accidental offsetting' was intended to comprise two aspects:
>
> a. the notion of an economic relationship between the hedged item and the hedging instrument, which gives rise to offset; and
>
> b. the effect of credit risk on the level of offsetting gains or losses on the hedging instrument and the hedged item, which may reduce or modify the extent of offsetting.
>
> The Board tentatively decided to disaggregate the umbrella term 'other than accidental offsetting' and instead to directly refer to those two aspects and add some application guidance.
>
> All Board members supported this decision.

Meaning of the requirement that a hedging relationship should produce an 'unbiased' result and minimise expected hedge ineffectiveness

Feedback from comment letters and from the outreach activities showed that while there was strong support for the overall move to a more principle-based assessment, there was uncertainty about how the different elements of the proposal relate to each other and about their meaning as well as concern about some of their implications. There was a general request for greater clarification.

The Board discussed the four elements of the objective of the hedge effectiveness assessment that were proposed in the ED:

- that the hedging relationship will produce an 'unbiased' result;
- that the hedging relationship will minimise expected hedge ineffectiveness;
- that the entity has no expectations that the changes in the fair value of the hedging instrument will systematically either exceed or be less than the changes in the fair value of the hedged item such that it will produce a biased result; and
- that the hedging relationship shall not reflect a deliberate mismatch between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness.

The Board noted that the reference to an 'unbiased' result was confusing and, as it is worded now, the proposals could be perceived as requiring entities to identify the 'perfect' hedging instrument as a starting point for hedge accounting instead of the instrument that is actually being used as the hedge. The Board also noted that referring to the term 'unbiased' creates the issue of referring to 'umbrella' terms that introduce abstraction and make the requirements less understandable.

The Board also noted the proposed requirement that the entity should have no expectations that the changes in the fair value of the hedging instrument will systematically either exceed or be less than the changes in the fair value of the hedged item can create a problem because the fair value of the hedging instrument at the time of designation is a present value. Hence, in situations in which a derivative is in- or out-of-the-money when designated as the hedging instrument there is an effect from the present value at that point that will accrete to the undiscounted amount (this is known as unwinding of the discount). As a result there would be an expectation that the changes in the value of the hedging instrument would systematically exceed or be less than those of the hedged item. The Board considered that this was neither intended nor useful.

As a result of its discussion of the elements the Board tentatively decided to remove the references to the umbrella term 'unbiased' and 'minimising expected hedge ineffectiveness' and the requirement that an entity should have no expectation that the changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item.

Instead the Board tentatively decided to proceed with an approach that refers more directly to the following:

(a) That an entity's designation of the hedging relationship shall be based on the 'economic hedge' ie:

   (i) the quantity of hedged item that it actually hedges; and

   (ii) the quantity of the hedging instrument that it actually uses to hedge that quantity of hedged item.

(b) However, the Board also tentatively decided that an entity shall not designate a hedging relationship such that it reflects an imbalance between the weightings of the hedged item and hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting. (Such an outcome might, for example, be intended to avoid recognising hedge ineffectiveness for cash flow hedges or to achieve fair value hedge adjustments for more hedged items with the aim of increasing the use of fair value accounting, but without offsetting fair value changes of the hedging instrument.)

All Board members supported this decision.