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Project **Financial Instruments: Hedge Accounting**

Topic **Disclosures—Dynamic strategies**

Purpose of this paper

1. At the 28 July 2011 IASB meeting, the Board discussed feedback on the hedge accounting disclosure requirements proposed in the exposure draft *Hedge Accounting*.
2. At that meeting, the Board did not make any decisions on disclosure requirements related to dynamic hedging processes. A dynamic hedging process refers to a situation in which entities hedge an exposure that is constantly evolving and as a result the designated hedging relationship needs to be frequently reset (ie hedging relationships need to be discontinued and new hedged items and hedging instruments need to be designated).
3. The Board has made tentative decisions on all other areas of disclosures.
4. This paper provides a discussion only within the context of dynamic hedging processes. This paper does not ask the Board to reconsider any of its previous decisions.
5. This paper asks the Board to exempt hedging strategies that use dynamic hedging processes from disclosing the terms and conditions of the hedging instrument. Instead, the entity should expand the explanation of its risk management strategy to allow users to understand how hedge accounting requirements are used to achieve the dynamic hedging strategy.

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.

Background

6. At the 28 July 2011 IASB meeting, the Board noted that many respondents were concerned that part of the proposed disclosure requirements regarding the timing, amount and uncertainty of future cash flows might lead to disclosure of commercially sensitive information (this refers to paragraph 46 of the exposure draft). Instead of that proposed disclosure, the Board tentatively decided to require entities to disclose[1]:

   (a) the principal, stated face or similar amount (notional amount) of the hedging instrument;

   (b) a profile of the timing of the notional amount of the hedging instrument. This is based on the terms of that instrument; and

   (c) if applicable, the average price or rate of the hedging instrument.

What is a dynamic hedging process?

7. For the purpose of this paper, a 'dynamic' hedging process refers to a situation in which entities assess their overall exposure to a particular risk and then designate hedging relationships for *constantly evolving exposures* that require frequent discontinuations and restarts of hedging relationships. This is particularly the case for hedges of open portfolios. Because the exposure draft facilitates hedges of groups and net positions in relation to *closed* portfolios, entities need to use a dynamic hedging process for an *open* portfolio. This means that entities designate hedging relationships for an open portfolio as if it were a closed portfolio for a short period and at the end of that period look at the open portfolio as the next closed portfolio for another short period. The

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[1] This paper asks the Board to exempt hedging strategies that use dynamic hedging processes from these disclosure requirements that the Board tentatively decided on at the 28 July 2011 IASB meeting.

dynamic nature of this process involves **frequent discontinuations and restarts of hedging relationships**.

8. Dynamic hedging processes were also discussed at the 2 June 2011 IASB meeting (see Agenda Paper 9 of that meeting). At that meeting, the Board discussed the distinction between risk management objectives and risk management strategies for the purpose of making it clear when hedging relationships need to be discontinued.

9. See the appendix to this paper for an example.

What is the problem?

10. Because of their dynamic nature, the hedging relationships will change continuously. Consequently, the staff think that providing information about the terms and conditions of the hedging instruments for such short-lived hedging relationships will not be useful. This is consistent with the staff view expressed at the 28 July 2011 IASB meeting (see Agenda Paper 1D of that meeting).

11. As explained in Agenda Paper 9 of the 2 June 2011 IASB meeting, hedge accounting is sometimes applied as a surrogate for 'dynamic' hedging. For example, under IAS 39 *Financial Instruments: Recognition and Measurement* many banks use a hedge accounting process that involves frequent discontinuation and restarts of hedging relationships. In these situations, the hedged item and the hedging instrument do not remain the same for long. Consequently, these entities tend to designate hedging relationships that are discontinued after only a short period (such as a month) and then replaced by a new hedging relationship that takes into account changes in the exposure and the related hedging instruments over that period.

12. The disclosure requirement related to the terms and conditions of the hedging instrument is designed to provide information for non-dynamic hedging strategies. In other words, when an entity hedges a risk that remains broadly the same over the entire hedged period, the proposed disclosure requirements

provide information about the terms and conditions of the hedging instruments that are used to manage the particular risk exposure. In dynamic hedging, hedge accounting merely acts as a surrogate to achieve an outcome that is directionally consistent with the entity's risk management strategy, but the hedging relationship must be frequently reset and hence does not last for the entire period for which the risk is hedged.

13. However, before we can address possible solutions for this problem, we need to determine what information will be disclosed as a result of the tentative decisions that the Board reached at the 28 July 2011 IASB meeting.

What information is already being disclosed?

14. At the 28 July 2011 IASB meeting, the Board decided that entities should:

    (a) Provide a description of their risk management strategy (see Agenda Paper 1B of the 28 July 2011 IASB meeting).

    (b) Provide tabular disclosures that will allow users of financial statements to understand the effects of hedge accounting on the financial statements (see Agenda Paper 1C of the 28 July 2011 IASB meeting).

15. Putting this into the context of the dynamic hedging process, an entity will:

    (a) first identify the risk category to which the dynamic process relates (for example, interest rate risk);

    (b) separate all the information disclosed as part of the dynamic risk management strategy from other interest rate risk management strategies (eg hedging a particular debt facility on a long term basis separately form open portfolios);

    (c) provide a detailed description of the risk management strategy; and

    (d) provide, in a tabular format, the effects of hedge accounting for this risk management strategy on the financial statements.

Staff analysis

16. The staff think that the Board has two alternatives. The Board can decide to exempt dynamic hedging strategies from disclosing the terms and conditions of the hedging instruments (**alternative 1**), or not to do so (**alternative 2**).

Alternative 1

17. For reasons explained in paragraphs 10-12 of this paper, the staff recommend that the Board should exempt entities from the disclosure requirement as described above when applying hedge accounting as a surrogate for dynamic hedging.

18. The staff think that it is more important for users to understand why entities use hedge accounting (as a surrogate) for dynamic hedging, than to provide them with information about the terms and conditions for the rather short life of the designated hedging instrument (which changes frequently).

19. The staff think that if entities apply dynamic hedging processes, the discussion of the risk management strategy should be expanded by requiring information about how the entity uses hedge accounting to reflect their risk management strategy. In other words:

    (a) information about what the ultimate risk management strategy is (for the dynamic hedging process);

    (b) a description of how it meets that objective by using hedge accounting and designating the particular hedging relationships; and

    (c) an indication of how frequently the hedging relationships are discontinued and restarted as part of the dynamic process.

Alternative 2

20. The Board could decide *not* to exempt dynamic hedging processes from disclosing the terms and conditions of the hedging instruments.

21. The advantage of this approach is that the Board does not create any exceptions from the disclosure requirements for hedge accounting. However, the disadvantage is that it requires entities to expend a considerable amount of effort to produce a disclosure that does not, in the staff's view, provide any useful information on dynamic hedging strategies (refer to paragraphs 10-12 of this paper).

22. The staff do not recommend that the Board adopt this approach.

Concerns raised at the 28 July 2011 meeting

23. At the 28 July 2011 Board meeting, the staff made the same recommendation as is in this paper. However, two concerns about the proposal to exempt dynamic hedging strategies from disclosing the terms and conditions of the hedging instruments were raised at that meeting. These are discussed below in more detail.

Concern 1—Describing a dynamic hedging process

24. Some Board members were concerned about how to describe (or define) dynamic hedging processes for the purpose of exempting them from the proposed disclosure requirement.

25. The staff do not think that a new defined term is required. The staff note that the Board had already decided to add an example to the application guidance of the final standard, which explains the difference between risk management objectives and risk management strategies using dynamic hedging processes as the basis for the example to illustrate when an entity should discontinue hedge accounting (see the appendix to this paper).

26. The staff think that the exemption (if the Board agrees with the staff recommendation) could refer to this example in the application guidance to illustrate the situations in which the exemption would apply.

Concern 2—Volumes of hedged items and hedging instruments

27. Some Board members were concerned that users will not be able to understand the volume of hedged items and hedging instruments that are included in the designated relationship at the reporting date.

28. The staff note that the disclosures requirements that are prescribed to explain the effects of hedge accounting on the financial statements already provide the answer (see Agenda Paper 1C of the 28 July 2011 IASB meeting). As part of the tabular disclosures, users of financial statements will be able to see the carrying amounts of both the hedging instruments and the hedged items (and the notional amounts of the hedging instrument). In other words, users will be able to see the volumes of the amounts that form part of the hedging relationships that are designated at the reporting date for this particular risk management strategy.

29. The staff note that because the designated hedging relationships frequently change, the specific relationships at the reporting date might not be representative of the normal volumes during the year. Consequently, if the Board agrees that hedging relationships for dynamic processes should be exempt from disclosing the terms and conditions of the hedging instruments, the Board could require entities to disclose when the volumes are unrepresentative of normal volumes during the year. This is similar to the disclosure requirement currently in IFRS 7 *Financial Instruments: Disclosures* on sensitivity analyses for market risk (see paragraph 42 of IFRS 7).

Staff recommendation

30. The staff recommend that the Board should exempt hedging relationships that are part of dynamic hedging processes from the requirement to disclose the terms and conditions of the hedging instruments. Instead, entities shall expand the description of their risk management strategy by providing:

(a) information about what the ultimate risk management strategy is (for the dynamic hedging process);

(b) a description of how it meets that objective by using hedge accounting and designating the particular hedging relationships; and

(c) an indication of how frequently the hedging relationships are discontinued and restarted as part of the dynamic process.

Question 1
Does the Board agree with the staff recommendation in paragraph 30? If not, why not and what would the Board prefer instead and why?

31. The staff recommends that the Board should require entities to disclose (if this is applicable) the fact that volumes of the hedging relationships (for dynamic hedging processes) do not represent normal volumes during the year. This is similar to the requirement in paragraph 42 of IFRS 7 that relates to the sensitivity analysis for market risk.

Question 2
Does the Board agree with the staff recommendation in paragraph 31? If not, why not and what would the Board prefer instead and why?

Appendix

Application guidance to help explain the difference between the risk management objective and the risk management strategy.

An entity hedges exposures that result from positions that frequently change, particularly interest rate risk of a portfolio of debt instruments. The addition of new debt instruments and the derecognition of debt instruments continuously change that exposure (ie it is different from simply running off a position that matures). This is a dynamic process where both the exposure and the hedging instruments used to manage it do not remain the same for long. Consequently, the entity frequently adjusts the hedging instruments used to manage the interest rate risk of the exposure as it changes. This would be the case in situations where debt instruments with 24 months' remaining maturity are designated as the hedged item for interest rate risk for 24 months. The same procedure is applied to other time buckets. After a short period of time the entity needs to discontinue the hedging relationship for all time buckets designated previously and designate new hedging relationships for all time buckets on the basis of their size and the hedging instruments that exist at that date. These discontinuations are not voluntary. Instead, hedge accounting must be discontinued. This is because the hedging relationships are established such 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 the previously designated hedging relationships.