Components of the hedge accounting model
Objective

Risk management objective: Seeks to link risk management and financial reporting (top down)

Accounting objective: Seeks to manage timing of recognition of gains or losses (bottom up)

Hedged items

Qualifying hedged item

Entire item

Component

Risk component (separately identifiable and reliably measurable)

Nominal component or selected contractual CFs
Hedged items: nominal components

- Proposals:
  - Two types of nominal components:
    - **Percentage component** (i.e., proportional to nominal amount of item)
    - **Layer component**
      - Type affects accounting outcome
  - Layers eligible for groups of items and individual items
    - Exception: if a prepayment option exists (unless the strike price is the fair value of the underlying)

Hedged items: risk components

- Fixed element
- Variable element
- Benchmark (e.g., interest rate or commodity price)
- Benchmark (e.g., interest rate or commodity price)
Hedged items: risk components continued

• Proposals:
  – LIBOR components in ‘sub-LIBOR’ interest bearing financial instruments
    – Designated risk component should not exceed the total cash flows of the hedged item
    – But: can still designate all the cash flows of the hedged item (for LIBOR risk!)
  ⇒ Retain the restriction in IAS 39

Hedged items: aggregated exposures

Aggregated exposure—combination of: (a) another exposure and (b) a derivative

- Debt holder
  - US$ to Issuer
  - Cross-currency Interest rate swap
    - US$ to €
    - € to €
  - Interest rate swap
    - € to €

Not an eligible hedged item under IAS 39
Hedging instruments

Qualifying hedging instruments

- Entire item
- Partial designation

FX risk component

- Intrinsic value
- Spot element

Percentage of nominal amount

Hedging instruments: time value of options

Fair value of option

- Time value
  - Reflects probability of being in the money in the future
  - Always ≥ 0 (for option holder)

- Intrinsic value
  - Value of being in the money
  - Is 0 if option is at or out of the money
Time value of options

Transaction related hedged item

Time period related hedged item

Option: time value continued

Accounting if the hedged item is transaction related

Cumulative gain in OCI

Cumulative loss in OCI

Time value paid

Life of option

Release from accumulated OCI to P/L or as a basis adjustment

Treatment as a cost of hedging reflects economics
Option: time value continued

Accounting if the hedged item is time period related

Cumulative amortisation of initial time value
Cumulative gain in OCI
Cumulative loss in OCI

Time value is amortised to P/L over life

Treatment as a cost of hedging reflects economics

Hedge effectiveness

Hedge effectiveness requirements (qualifying criteria):
1. Objective of effectiveness assessment is met
2. More than accidental offset

Measuring and recognising hedge ineffectiveness
Discontinuation and rebalancing

Objective of hedge effectiveness assessment not met

Risk management objective remained the same

The risk management objective changed

Other than accidental offset

Merely accidental offset

Discontinue hedge accounting

Continue Hedge accounting

Discontinue hedge accounting

Effectiveness assessment continued

Original hedge ratio

‘Perfect’ ratio with benefit of hindsight

Revised hedge ratio

New trend

Rebalancing

One (continuing) risk management and hedge accounting relationship
Recognise hedge ineffectiveness

- **Proposals:**
  - *All* hedge ineffectiveness must be recognised
    - Includes effect of **credit risk**
    - Includes **time value of money** (difference in timing of cash flows)
  - Measurement on a 'dollar offset' basis
  - ‘Hypothetical derivative’…
    - Not a separate method (same for effectiveness assessment!)
    - One possible way to determine the change in value of the hedged item

Groups and net positions

- Hedge accounting model for individual items **plus**
- Eligibility of a group of items as hedged items
- Designation of a component of a nominal amount
- Presentation
- Nil net positions
Hedged items: groups and net positions

• Issues:
  – Alignment of hedge accounting with common risk management practice
  – Identification and tracking of hedged items in a group hedge
  – Net positions—allocation of hedge gains/losses:
    – profit or loss geography (single line vs grossing up of gains and losses)
    – groups that include income/expense items and assets/liabilities

Hedged items: groups and net positions continued

• Proposals:
  – Net positions as eligible hedged items:
    – Conditions:
      – Consistent with risk management
      – Items identified on a gross basis
    – √ Fair value hedges
    – √ Cash flow hedges:
      → Only if offsetting cash flows affect profit or loss (in their entirety) in the same period
Hedged items: groups and net positions continued

- Proposals:
  - Change in fair value of individual hedged items need not be proportional to that of the group
  - Permit layer approach (eg bottom layer) to identifying hedged items from a group
  - Separate line item presentation of hedging instrument gains or losses for net position hedges if group has offsetting risks
    - For example sales and purchases hedged for FX risk or interest revenue and expense

Presentation of fair value hedges

- Hedge Accounting in one place—OCI
- Transparency for hedging effectiveness and ineffectiveness
- Balance Sheet carrying amounts not adjusted

Comprehensive picture of hedge accounting effects in one place
Disclosures: scope

Proposed scope for hedge accounting disclosures

- Total entity risk exposure (no specific disclosure requirements)
- Hedged exposure (Exposure to risks being hedged)
- IFRS 7 Disclosure requirements
- Significance of financial instruments for financial position and performance
- Nature and extent of risks arising from financial instruments
- Entity’s exposure attributable to the hedged risk

Disclosures proposed

- Hedge accounting disclosures
- Risk management strategy
- The amount, timing and uncertainty of future cash flows
- Effects of hedge accounting on the primary financial statements
Alternatives to hedge accounting

Alternatives

- 'Own use' scope exception in IAS 39
- Credit derivatives (not proposed)
- Proposed consequential amendment
- Fair value accounting (3 alternatives considered)

Knock-on effects of other project phases

- **Proposals:**
  - Embedded derivatives
    - embedded derivatives are eligible hedging instruments only if separated from their host contract
      \(\Rightarrow\) no longer available under IFRS 9 for asset host contracts
  - **Equity investments for which the OCI presentation alternative is elected**
    - hedge accounting is not available for instruments designated at fair value through OCI
  - Impairment
    - interaction of expected loss model with ‘highly probable’
Transition and effective date

• Proposals:
  – Transition requirements
    – Prospective application of new hedge accounting model to all hedging relationships
    – Hedging relationships that qualified under IAS 39 and qualify under the new model will be treated as continuing hedging relationships
    – No restatement of comparatives
  – Effective date
    – Annual periods beginning on or after 1 January 2013 with earlier application permitted
    – all existing IFRS 9 requirements must be adopted at the same time (or already have been adopted)

Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.