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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **July 2006, London**

Project: **IAS 39 *Financial Instruments: Recognition and measurement***
Identification of a portion of an exposure eligible for hedge accounting (Agenda paper 9)

Introduction

1. Paragraphs 78 to 84 of IAS 39 *Financial Instruments: Recognition and Measurement* provide guidance on qualifying hedged items. In particular, paragraph 81 provides guidance in respect of designating financial items as hedged items, stating:

   If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a <u>*portion*</u> *of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).* (Emphasis added)

2. Identifying the portion of cash flows or fair value that is being hedged is important for assessing whether the hedge is expected to be highly effective [IAS39.88(b)]. Unless a hedge relationship is expected to be highly effective, it will not qualify for hedge accounting.

3. There is little guidance in IAS 39 relating to 'portions' and the IFRIC Agenda Committee has received a number of submissions asking whether the risks associated with a specific portion of an exposure might qualify for hedge accounting. For example, the IFRIC has been asked whether inflation risk could qualify as a hedged portion of an interest bearing asset or liability.

4. At the March 2006 meeting the IFRIC agreed that the guidance in paragraph AG100 may be relevant to the identification of portions of financial assets and liabilities eligible for hedge accounting.

5. This paper explores whether there is a principle within AG100 that can be used to develop guidance on what qualifies as a hedged portion under IAS 39.

6. This paper does not directly deal with the specific situations highlighted in the submissions. However, if the members can reach an agreement on a principle, we would then seek to apply that principle to specific situations.

Summary of possible ways forward

7. The staff believes that, whilst it may be possible to develop some guidance out of the analysis contained in this paper, the current wording of IAS 39 does not provide a strong enough basis in itself to develop a robust principle. However this is, of course, a judgement we are asking the IFRIC to make (see section on 'Questions for the IFRIC').

8. Before asking the IFRIC to make that specific judgement, however, the staff believes it worthwhile to set out the alternative ways forward. These include that:

    a. The IFRIC believe that the current wording of IAS 39 *does* provide a strong enough basis in itself to develop a robust principle and, assuming the criteria for a draft Interpretation (as set out in paragraph 27 of the

IFRIC *Preface*) are met, then the IFRIC proceed to a draft Interpretation, or

b. The IFRIC believe that the current wording of IAS 39 does *not* provide a strong enough basis in itself to develop a robust principle, and permits practice to develop based on the current guidance in IAS 39. To the extent that the IFRIC does receive (or has already received) submissions relating to this topic, the IFRIC could either address them on an individual basis or decline to take them onto the agenda (for example, because the IFRIC does not feel that they could reach a consensus on a timely basis), and/or

c. The IFRIC could refer this issue to the Board. However, if the IFRIC decides on this course of action the IFRIC may first want to formulate some proposals for the Board to consider (for example, developing a workable principle regarding the hedging eligibility criteria for risks associated with a specific portion of an exposure).

Questions for the IFRIC

Does the IFRIC believe that paragraph AG100 has any implications for the eligibility criteria for a hedged item (as set out in paragraph 88)?

If the IFRIC believes that paragraph AG100 *does* have implications for the eligibility criteria of a hedged item, then which of the possible interpretations of AG100 that have been identified by the staff (summarised in paragraphs 12 - 15) do the IFRIC believe appropriate. If the IFRIC do not believe any of the identified interpretations of AG100 to be appropriate, then what interpretation of AG100 do IFRIC members believe to be appropriate?

If the IFRIC *does not* believe that paragraph AG100 has any implications for the eligibility criteria of a hedged item, do IFRIC members believe that other guidance in IAS 39 might be relevant in developing a principle leading to a draft Interpretation? If so, what guidance and how will it help in developing a principle?

Which of the alternative ways forward described in paragraph 8 does the IFRIC wish to pursue?

Summary of the paper

9. This paper analyses the hedge accounting criteria in paragraph 88 of IAS 39 and concludes that a hedged portion must be (i) identifiable; and (ii) capable of reliable (and separate) measurement.

10. The staff believe that AG 100 of IAS 39 could be interpreted as providing guidance on when a hedged portion is identifiable. That is, AG 100 requires that a change in the risk(s) of an identifiable hedged portion must have (i) a predictable effect; and (ii) a separately measurable effect on the price of the hedged item.

11. This paper discusses a number of possible interpretations of the phrases "predictable effect" and "separately measurable effect".

12. The staff believe that the requirement for changes in the risks of a hedged portion to have a separately measurable effect on the price of the hedged item could be interpreted as preventing an entity from obtaining hedge accounting for residual risks (see paragraphs 32 - 33).

13. An additional (or alternative) interpretation of a requirement for a separately measurable effect of the portion of hedged risks is that there needs to be a quoted/active market for the risks associated with a hedged portion of an item or transaction (see paragraphs 34 - 35).

14. The staff believe that a requirement that a change in the risk(s) of a hedged portion should have predictable effect on the price of the hedged item could be interpreted as follows:

    a. The price of the hedged item or transaction will change as a consequence of a change in the risks associated with a hedged portion of that item or transaction, assuming all unhedged risks of the exposure remain constant; or, alternatively

    b. A change in the price of the hedged item or transaction must be 'observable' as a consequence of the risks associated with a hedged portion of an item or transaction changing.

15. The paper does not conclude which of these possible interpretations is correct as the staff believe that the standard is unclear.

Staff analysis

The criteria for hedge accounting

16. Paragraph 88 of IAS 39 sets out the criteria that must be met if an entity is to qualify for hedge accounting. The staff believe that paragraph 88(a) and 88(d) are relevant when considering whether a portion of an item can be designated as a hedged item.

17. Paragraph 88(a) states that:

    At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include the identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk. (Emphasis added)

18. Paragraph 88(a) therefore discusses (amongst other things) the *issue of identification* of the hedged item and the nature of the risk being hedged.

19. Paragraph 88(d) states that:

> *The effectiveness of the hedge can be reliably measured, i.e. the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured…* (Emphasis added)

20. Paragraph 88(d) focuses on the requirement to be able to *reliably measure* the fair value or cash flows of the hedged item that is attributable to the hedged risk.

21. These two requirements are clearly linked. That is, it is difficult to argue that you can reliably measure the hedged item if the hedged item has not first been identified. Consequently, this paper focuses on the identification requirements of paragraph 88(a).

Identification of the hedged item

22. For situations in which, for example, an asset or liability is designated as a hedged item in its entirety for all risks then paragraph 88(a) is not problematic – the hedged item is clearly identifiable. However, the identification of a *specific portion* of an exposure as the hedged risk in a hedge accounting relationship is not so straight-forward.

23. The difficulties relating to identification of the hedged item were one of the reasons given by the Board for not permitting portions of non-financial assets and non-financial liabilities to be designated as the hedged item for risk other than foreign currency risk (see paragraph BC138 of IAS 39).

24. There are a number of other references to the principle of identification of the hedged item throughout IAS 39, namely:

    a. Paragraph 81 (designation of financial items as hedged items) refers to "an "identifiable…portion…"

    b. Paragraph 82 (designation of non-financial items as hedged items) refers to the difficulty of "isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks…"[1] [Emphasis added].

25. Therefore, the staff believe it is necessary to consider what is required to identify a portion of a hedged item.

26. At the March 2006 IFRIC meeting possible implications of paragraph AG100 of IAS 39 to portions of exposures of financial assets and liabilities were discussed. The IFRIC agreed that paragraph AG100 may be relevant to the identification of portions of financial assets and liabilities.

27. Paragraph AG100, which primarily discusses the designation of non-financial items as hedged items, states that:

    Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of an item that is comparable to the effect of, say, a change in market interest rates on the price of a bond. (Emphasis added)

28. The staff believe that AG 100 of IAS 39 could be interpreted as providing guidance on when a hedged portion is identifiable for the purposes of paragraph 88(a). That is, AG 100 requires that a change in the risk(s) of an identifiable hedged portion must have (i) a predictable effect; and (ii) a separately measurable effect on the price of the hedged item.

29. Paragraph AG100 of IAS 39 provides two examples of what is meant by this wording, namely:

    a. The effect of a change in market interest rates on the price of a bond, and

    b. The effect of a change in foreign exchange rates on a non-financial asset or liability.

30. These examples would appear to imply that the requirement that the hedged portion has a predictable, separately measurable effect on the price of the hedged item should be interpreted as requiring some form of 'economic relationship'

[1] The staff believes that the reference to "isolating" in paragraph 82 is also relevant to the "separately measurable effect" in paragraph AG100. See later comments.

between the hedged portion of risks and the item or transaction. In order to understand the nature of this ‘economic relationship’, it is necessary to explore what is meant by predictable and separately measurable.

What is meant by “separately” measurable effect?

31. Taking the “<u>separately</u> measurable effect” first. The question could be – separate from what?

32. Given the context of paragraph AG100 (i.e. discussion regarding the hedged item), then presumably this means being able to measure an effect separately from the hedged asset or liability itself. That is, the fair value or cash flows of the portion must be capable of being measured separately from the overall fair value or cash flows of the asset or liability to be considered ‘identifiable’ for the purposes of paragraph 88(a).

33. Such an interpretation would mean that a “residual” risk would not be eligible for hedge accounting – that is, an entity would not be permitted to designate as a portion the residual fair value or cash flows of the hedged item or transaction, as such a portion could not be measured separately from the hedged item or transaction itself. For example, it would not be possible to designate as a hedged portion changes in the fair value of a bond, excluding credit risk. It would however be possible to designate as a hedged portion changes in the fair value of a bond attributable to the bench-mark interest rate (assuming the other eligibility criteria have been met).

34. An alternative interpretation of “separately measurable effect” might be that the risks associated with the portion should also be ‘independently observable’. That is, qualifying hedged portions would be restricted to certain traded/quoted risks for example: inflation, interest rates, credit risk, market price risk (for traded financial assets and liabilities) and foreign exchange risk.

35. In practice, the staff believes that such a restriction would normally be met, as most derivatives that are used to hedge an exposure are themselves priced off traded or quoted risks. However, there may be situations in which this is not the case.

36. These interpretations of “separately measurable”, however, do not explain why the Board disallowed risks associated with portions of exposures of non-financial items (with the exception of foreign exchange) to qualify as the hedged item for hedge accounting (paragraph 82 of IAS 39).

37. Many such risks relating to non-financial items are independently observable. However, as noted in the IFRIC Update in October 2004, the IFRIC agreed that IAS 39 was clear that non-financial items could not be separated into price risk components, even if the price risk component relates to an efficient, liquid and regulated commodity exchange.

38. Therefore, whichever meaning of “separately measurable” is accepted, there would appear to be further restrictions surrounding what can be designated as a hedged risk.

What is meant by “predictable…effect”?

39. The New Oxford Dictionary of English defines “predict” as follows:

    <u>*Say or estimate that (a specified thing)*</u> *will happen in the future or* <u>*will be a consequence of something*</u>*.* (Emphasis added)

40. Paragraph AG100 is clear that “the specified thing” is an effect on the price of the item (such as the underlying hedged item or transaction).

41. The “consequence of something” is presumably a change in the risks associated with the identified portion of exposure of the hedged item or transaction.

42. Putting these two parts together, a “predictable…effect on the price of the item” arguably means that the consequence of a change in the risks associated with the identified portion is <u>an effect</u> on the price of the underlying hedged item or transaction.

43. Or, put another way, is there a predictable effect on the price of a (non-government) bond if the benchmark interest rate rises? AG 100 would imply that the answer to this is yes.

44. Is it sufficient that we simply know that the price of the bond would go up or down if there is a change in interest rates? The use of the word “effect” could

imply that we must also be able quantify the impact of a change in the hedged portion of risks on the fair value of the bond. Such a requirement would be consistent with the requirement to “separately measure”.

45. In order to quantify the effect of a change in benchmark interest rates on the price of a bond, we would have to assume that the credit spread (which presumably is a different ‘portion’ of risks or alternatively composed of residual risks) has not fallen – or at least has not fallen enough to offset the impact on the price of the bond for the increase in the benchmark interest rate.

46. It could therefore be argued that the assumption (when assessing whether or not there is an effect) is that all other risks of the hedged item or transaction not associated with the identified portion remain constant.

47. The staff note that such an assumption is inconsistent with the fact that the Board decided not to permit risks associated with portions of exposures of non-financial items to be eligible as hedged risks; a change in the price of crude oil would surely, if all other variables were held constant, change the price of jet fuel (and there are many other examples). However, the relationship between the risks of such an identified portion and the impact on the hedged item or transaction was felt (in many circumstances, anyway) to not meet the benchmark required of having a ‘predictable, separately measurable effect on the price of the item’.

48. The staff believes that it can therefore be argued that the wording in AG100 implies that an assumption that such other variables are kept constant is not necessarily valid and that there needs to be some ‘higher’ test.

49. Such a test could be that there needs to be an <u>observable</u> linkage between a change in the risks associated with the identified portion and a change in the price of the underlying hedged item or transaction. That is to say, if the benchmark interest rate rises then there should be an ‘observable’ impact on the price of the bond.

50. This approach is consistent with the concept of hedge accounting. Hedge accounting is permitted when there is offset between changes in the fair value or cash flows of the hedged item and the fair value or cash flows of the hedging

instrument (assuming all the eligibility criteria have been met). If a change in the risks associated with a hedged portion does not have an observable effect on the fair value or cash flows of the hedged item, it is difficult to argue there is any offset with the hedging instrument.

51. Such an approach, however, is very judgemental – for example:

    a. What is meant by 'observable' - would a change in the hedged risks associated with a portion *always* have to result in an impact on the item or transaction, or would an expectation that a change in the hedged risks associated with a portion *would normally* result in an impact on the item or transaction be sufficient?

    b. What about hedged items or transactions where there is no quoted price? In the absence of a quoted price for a hedged item or transaction, would it be sufficient that an entity expected that a change in the risks associated with a portion of the exposure of the hedged item or transaction would impact the price? If so, how different is this from assuming that all the risks of the hedged item or transaction that are not being hedged remain constant?

52. Possible implications of such an approach include:

    a. Risks associated with 'portions' that form a small part of the overall risks of a hedged item or transaction, and for which one is not able to observe a link between a change in the risks associated with that portion and a consequential impact on the price of the hedged item or transaction, would not be eligible portions under paragraph 88(a) of IAS 39.

    b. The benchmark rate itself might not always be eligible for hedge accounting. For example, a change in the benchmark rate may have no or little impact on the price of a 'C' rated bond

    c. It would not be possible to designate as a hedged item changes in the fair value of a UK mortgage attributable to changes in US interest rates; it would not be possible to predict the impact that a change in US interest rates would have on the fair value of a UK mortgage.