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IFRS Developments

Important changes to hedge accounting – but also a further delay

What you need to know

At its January 2013 meeting, the International Accounting Standards Board made some important changes and clarifications to the standard on hedge accounting.

- The Board considers currency basis spreads included in the forward element of a currency forward contract or a cross-currency interest rate swap to be a 'cost of hedging'.
- Entities will be able to account for changes in the currency basis spread in other comprehensive income (OCI).
- This would apply to both cash flow hedges and fair value hedges, significantly reducing profit or loss volatility compared to the current treatment of fair value hedges under IAS 39 *Financial Instruments: Recognition and Measurement*.
- The IASB confirmed its earlier decision not to carry forward to IFRS 9 the specific guidance on macro cash flow hedge accounting in the IAS 39 *Implementation Guidance*. It clarified that this does not mean entities cannot apply macro cash flow hedge accounting strategies under IFRS 9.
- However, the Board also decided to perform further limited outreach to understand the concerns of constituents about the application of macro cash flow hedging strategies under IFRS 9.

Highlights

In September 2012, the International Accounting Standards Board (IASB, the Board) issued a draft of the final standard IFRS 9 *Financial Instruments - Chapter 6 Hedge Accounting* (the draft standard). Although not specifically requested by the Board, many constituents have taken the opportunity to comment on the draft standard. At its January 2013 meeting, the IASB made significant decisions on the draft standard that address the main concern raised by constituents.

However, the Board has also decided to perform further limited outreach to understand concerns raised by constituents about the application of macro cash flow hedging strategies under IFRS 9. Consequently, this is likely to delay the publication of the final standard.

Accounting for currency basis spreads as a cost of hedging

Paragraph B6.5.5 of the draft standard clarifies that an entity may use for measuring ineffectiveness, *"a derivative that would have terms that match the critical terms of the hedged item (this is commonly referred to as a 'hypothetical derivative')"*. The draft standard also clarifies that the hypothetical derivative method is not a method in its own right. Consequently, it goes on to say that a hypothetical derivative may not *"include features in the value of the hedged item that only exists in the hedging instrument (but not in the hedged item)"*. Constituents certainly welcome these clarifications as the application of the hypothetical derivative, although commonly used in practice, is not specifically addressed by IAS 39.

However, B6.5.5 mentions currency basis spreads in cross-currency interest rate swaps (CCIRS) as one example of a feature that is only present in the hedging instrument, but not in the hedged item.

The Board has decided that currency basis spreads are a 'cost of hedging'. The cost of a hedging activity should be recognised in profit or loss at the same time as the hedged transaction.

Currency basis spread

The currency basis spread, a phenomenon of the financial crisis, is the charge above the risk-free rate of a foreign country to compensate for country and liquidity risk. This charge only applies to transactions exchanging foreign currencies at a future point in time (as, for example, in currency forward contracts or CCIRS).

Historically, the difference between the spot and forward price of currency forward contracts and CCIRS comprised the differential between the risk free interest rates of the two currencies involved. However, basis spreads increased significantly after the financial crisis and the following sovereign crisis and have become a significant and volatile component of the pricing of forward contracts and CCIRS.

Excluding the currency basis spread from the hypothetical derivative would result in ineffectiveness when using currency forward contracts or CCIRS as hedging instruments, both for fair value hedges and cash flow hedges. Constituents considered this a significant change to current practice for cash flow hedges, in which usually no ineffectiveness is recorded from changes in currency basis risk.

The Board has decided that currency basis spreads are a 'cost of hedging'. The cost of a hedging activity should be recognised in profit or loss at the same time as the hedged transaction. Consequently, the Board decided to expand the existing draft requirements regarding the accounting for the forward element of forward contracts to also include currency basis spreads. This would mean that:

- For transaction-related hedged items – the changes in the currency basis spread are recorded in OCI and taken out of the separate component of equity as a basis or reclassification adjustment when the hedged transaction occurs.
- For a time-period related hedged item – the changes in the currency basis spread are recognised in OCI, with amortisation of the currency basis spread existing at designation of the hedge on a systematic and rational basis from OCI to profit or loss over the hedging period.

The above accounting, which is similar to the accounting for the time value of options when the intrinsic value only is designated, would apply to cash flow hedges and fair value hedges alike.

How we see it

The proposed changes not only address constituents' concerns regarding cash flow hedge ineffectiveness, but, at the same time, they also significantly reduce profit or loss volatility on fair value hedges. Therefore, we welcome the Board's decision.

It should be noted that the above Board proposal is an exception for currency basis spreads only and does not introduce a general principle of 'cost of hedging'.

The determination of the currency basis spread component of the fair value of the hedging instrument will add considerably to the operational difficulties of hedge accounting.

Applying macro cash flow hedge accounting under IFRS 9

At its meeting in May 2012, the IASB decided to decouple the project on accounting for macro hedging from IFRS 9 while, at the same time, allowing entities to still make use of fair value hedge accounting for portfolio hedges of interest rate risk, as defined in IAS 39, until the macro hedge accounting project is finalised and becomes effective. However, the IAS 39 *Implementation Guidance* (the IG) also contains specific guidance for the application of cash flow hedge accounting when financial institutions manage interest rate risk on a net basis (IAS 39 IG F.6.2 and F.6.3). In May 2012, the IASB decided not to carry forward these IG to IFRS 9. As a result, many financial institutions were concerned that they would not be able to continue with their macro cash flow hedging strategies under IFRS 9.

The Board has confirmed its earlier decision and clarified that not carrying forward the IG was without prejudice (i.e., it does not mean that entities cannot apply macro cash flow hedge accounting under IFRS 9). The Board also noted that the IG is not an integral part of IAS 39. Macro cash flow hedge accounting is only a method of applying the hedge accounting model, whereas macro fair value hedge accounting is an exception to the model. Consequently, carrying forward the IG might imply that current macro cash flow hedge accounting is inconsistent with the new hedge accounting model.

At the same time, the Board also clarified another aspect of the new hedge accounting model, with particular relevance for macro cash flow hedging strategies. The aim of macro hedging strategies of financial institutions is to hedge the interest margin risk arising from interest bearing financial assets and financial liabilities held at amortised cost. The hedge designation, however, is either a cash flow hedge (to hedge variability of forecast cash flows) or a fair value hedge (to hedge variability of fair values), neither of which is entirely consistent with the actual risk management activity to hedge variability in the interest margin. Furthermore, for cash flow hedges, financial institutions would usually designate net cash flows as hedged items. However, paragraph 6.6.1(c) of the draft standard restricts net position cash flow hedges to hedges of foreign currency risk.

This raises the question whether an entity can designate hedges that do not perfectly reflect the underlying risk management activity (often referred to as ‘proxy hedges’). This is of particular relevance as the objective of the new hedge accounting model is *“… to represent, in the financial statements, the effect of an entity’s risk management activities.”* The Board has now clarified that proxy hedges are permitted, provided the designation is ‘directionally consistent’ with the actual risk management activity. Designating a net cash flow as a gross position would be directionally consistent with a risk management strategy of hedging net positions, therefore, eliminating the conflict with paragraph 6.6.1(c).

As a second clarification, the Board has decided to expand the example in paragraph B6.5.24(b) to state that dynamic hedging strategies have to be discontinued in line with risk management (i.e., partial or full discontinuation).

The Board’s objective was to have a separate project on the accounting for macro hedging while, in the meantime, not restricting entities that currently apply macro hedging strategies under IAS 39. Despite the above clarifications, the Board is not yet satisfied that this objective will be met. Hence, the Board decided to perform further limited outreach to understand the concerns raised by constituents.

How we see it

We welcome the IASB’s clarification that financial institutions can apply macro cash flow hedge accounting under IFRS 9.

In addition, the clarifications on proxy hedges will have a wider benefit that will assist non-financial institutions as well.

However, as a result of the additional outreach that is planned, we do not expect the final standard to be issued before the second quarter of 2013.

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