
Project	Financial Instruments (Replacement of IAS 39) – Hedge Accounting
Topic	Eligibility of hedged items: groups and net positions – identifying the hedged item (the ‘what’ issue) – cover paper

Introduction

Background and purpose of this paper

1. In recent board meetings the board has discussed eligibility of groups of hedged items. Initial discussions considered groups of items that constitute a gross position¹. We then moved on to groups of items that are net positions².
2. Hedging groups of items gives rise to the issue of how to identify the hedged items in the group.
3. These discussions continue to be part of the general hedging model that considers closed portfolios. See paragraph 20 for discussion of open portfolios vs closed portfolios.
4. The purpose of this paper is to:
 - (a) remind the board why we need to identify the hedged item when applying hedge accounting;

¹ See papers 9 & 9A from May board meeting (group of different corn seed firm commitments hedged for benchmark corn price risk and group of equities that replicate an index hedged for equity price risk using an equity index linked put option).

² See papers 9B & 9C from May board meeting (net positions of firm commitments) and papers 6 & 6A from this month’s board meeting (net positions of forecast transactions).

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

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- (b) briefly outline different considerations for identifying the hedged items in a group hedge; and
 - (c) outline the staff's approach to analysing the alternatives for identifying the hedged item.
5. Subsequent papers will analyse alternatives for identifying the hedged items in a group hedge in the context of:
- (a) groups that constitute gross positions; and
 - (b) groups that constitute net positions.
6. The board should note that the appropriateness of the alternatives will to some extent depend on the nature of the hedged item. For example an approach for existing hedged items (eg assets, liabilities, firm commitments) may not be appropriate for anticipated items (eg forecast transactions). This paper more generally outlines the potential alternatives and does not discuss the appropriateness of application. This will be in subsequent papers.
7. There are no questions for the board in this paper.

Why we need to identify the hedged item

8. Identifying the hedged item is necessary to
- (a) Assess effectiveness of the hedge relationship (ie effectiveness testing).
 - (b) Measure ineffectiveness of the hedge relationship.
 - (c) Determine *when* to reclassify to profit or loss amounts deferred in equity under the cash flow hedge mechanics of hedge accounting.
 - (d) Determine *where* in the income statement to recognise gains/losses from hedging instruments³.

³ For net position hedges, reference to 'hedging instrument' gains/losses includes those gains/losses arising from hedged items that serve a dual role of acting as both hedged item and hedging instrument (see Agenda Paper 6).

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Different considerations for identifying hedged items in a group hedge***Specific identified hedged items vs abstract amounts of hedged items***

9. If a group of items, say firm commitments, is designated in a single hedge relationship those items could be individually identified and tracked as hedged items. This would be a 'specific designation'.
10. A specific designation allows the requirements noted in paragraph 8 to be done more accurately and objectively as under such a designation there would be less doubt over 'what' the hedged item is. As such there would be less (or no) scope for substitution of the designated hedged items if their timing changed or they were cancelled (firm commitments) or did not arise (forecast transactions). That means if there were other known *undesigned* qualifying items available for the duration of the hedge, giving rise to the same exposure, they could not be used in place of the designated exposures that have changed, been cancelled or did not arise. To use different hedged items would require formal designation of those items.
11. For risk management purposes, specific items are more often identified when only single items are hedged on a matched-terms basis to create a synthetic hedged position. Specific items are less often identified under risk management of groups of items.
12. As a result, although identifying specific hedged items helps to comply with the requirements in paragraph 8, it is often not consistent with risk management procedures. Furthermore, it introduces application complexities arising from having to track individual hedged items for amortisation or reclassification purposes.
13. An alternative to identifying specific items could be to identify the hedged item as an abstract *amount* of an identified group of specific items (eg an abstract amount of €100m assets from a specific portfolio of €500m assets).

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14. If an abstract amount of a group of hedged items could be identified for hedge accounting, further consideration of how to comply with the requirements in paragraph 8 would be needed.

Proportions vs portions (or 'layers')

15. Where a group of items is not hedged in its entirety (ie 100% of each item in the group) it is necessary to determine how the part that is designated in the hedge is identified. This is necessary regardless of whether specific hedged items have been designated or an abstract amount of a portfolio is designated (see paragraphs 9 to 14).
16. In both of these cases the hedged amount could be identified as either a:
 - (a) proportion of the total (eg 80% of a specific item or 80% of a portfolio of items); or
 - (b) portion of the total (eg the £80m bottom layer of a specific £100m asset or the £400m bottom layer from a portfolio of £500m assets).

Net positions vs gross positions

17. A group of items that constitutes a net position can be characterised as a combination of two groups that each individually constitute gross positions but partially offset. For example a single group that is a net position of assets and liabilities can be characterised as a combination of two groups – one group of assets and one group of liabilities.
18. As a result the considerations for identifying the hedged item for groups that are net positions are in many cases the same as those considerations that apply to groups that are gross positions. In other words the alternatives for identifying the hedged items in a group that is a gross position equally apply to groups that are net positions.
19. However, a question arises over whether a net position can be identified without reference to gross positions. For example instead of referring to a net position as

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a combination of 100 assets and 80 liabilities it is simply referred to as a net position of 20 assets which could be made up of any combination of gross items (eg it could be 21 assets and 1 liability or 120 assets and 100 liabilities, etc). Furthermore if the net position of 20 is not hedged in its entirety, can a part of that net position be identified as proportion or portion of the whole net position.

Open portfolios vs closed portfolios

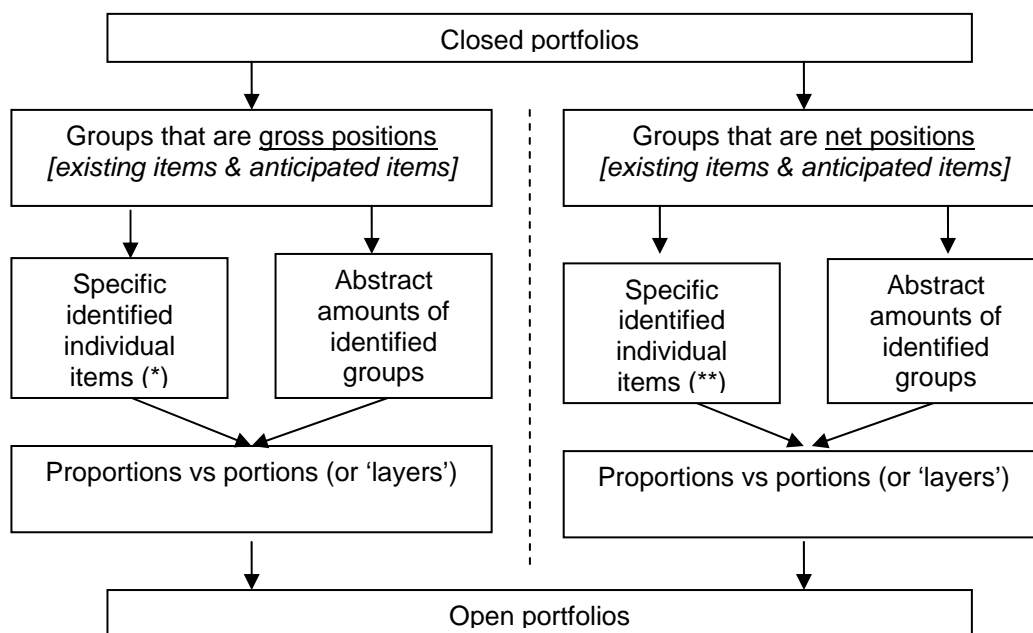
20. The above discussions have been in the context of closed portfolios of items that are not added to. However in practice, risk management processes assess risk exposures on a continuous basis. Risk management strategies tend to have a time horizon (eg 2 years) out to which a proportion or portion of risks are hedged. Therefore, as time passes new exposures are continuously added to the hedged portfolio and old exposures are realised and removed from the portfolio. This introduces significant complexity to the accounting of such hedges. Changes could be dealt with by periodic de-designation of the previous closed portfolio of items and redesignation of a revised closed portfolio of items. However, this gives rise to complexities regarding tracking, amortising hedge adjustments and reclassification of gains/losses deferred in OCI. Furthermore it may be impractical to align this with the way in which the exposures are viewed from a risk management perspective which may update hedged portfolios more frequently, say daily. An alternative could be a hedge accounting model that automatically accommodates new hedged items and hedging instruments into the hedge designation.

Next steps and sequencing of papers for discussion

21. Given the various considerations above, subsequent staff papers will begin to discuss and analyse different ways to identify the hedged items from a group of items. These discussions will separately consider:
- (a) both gross positions and net positions, of
 - (b) both existing items and anticipated items, that are

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- (c) hedged both in full and in part, and are
- (d) identified as specific items and abstract amounts.



(*) see paragraph 22

(**) This is considered in agenda paper 6C (see paragraph 23)

- 22. The first of these papers (Agenda Paper 6C) considers alternatives for identifying UUUnet positions as combinations of *specific* identified items. This paper does not consider whether parts of hedged items are identified as proportions or portions.
- 23. It is noted that identifying hedged items as *specific* items for groups of *existing* items that are gross positions is permitted under IAS 39 and will not be discussed as this is not an area under review.