



International Accounting Standards Board®

Press Release

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IASB PUBLISHES PROPOSALS ON MACRO HEDGING

The International Accounting Standards Board (IASB) today published proposals to improve the implementation of IAS 39 *Financial Instruments: Recognition and Measurement*. The proposals are set out in an Exposure Draft of proposed amendments to IAS 39. If adopted the proposals would enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk (sometimes referred to as ‘macro hedging’). The Exposure Draft retains the basic principles behind IAS 39 while aiming to reduce the cost of compliance. The detailed proposals are summarised in the attached note.

IAS 39 (along with Japanese and US standards) is one of the three broadly similar approaches in accounting standards that provide comprehensive guidance for the accounting for financial instruments. The need for such guidance is driven by the increasingly prevalent use of financial instruments for both risk management and other operating purposes. At the end of 2002, the Bank for International Settlements estimated that the total estimated notional amount of over-the-counter (OTC) derivatives contracts stood at US\$141.7 trillion, and the gross market values of those contracts was \$6.4 trillion.* Without a standard such as IAS 39, the use of derivative contracts for an individual company’s accounts would be unknown to investors. Financial instruments would be shown in a company’s financial reports either at cost—which is generally zero—or not at all.

The release of this Exposure Draft is part of the IASB’s continuing process of improving and easing the implementation of IAS 39, a standard developed over a 12-year period by the IASB’s predecessor International Accounting Standards Committee (IASC). The IASB published its first round of proposed improvements for public comment in June 2002.

Based on the comments received and a series of public roundtable discussions held in March 2003, the IASB launched intensive discussions with interested parties, including banking representatives, to find a way within the principles of IAS 39 to accommodate macro hedging. Whilst the discussions did not produce complete agreement on the measurement of

* Statistics from *OTC derivatives market activity in the second half of 2002* (Monetary and Economic Department, Bank for International Settlements: Basel, 8 May 2003).

hedge ineffectiveness and deposit liabilities, the IASB's approach set out in the Exposure Draft would mark an important advance by permitting macro hedging. Furthermore, consistently with the IASB's established due process, the Basis for Conclusions on the Exposure Draft includes a discussion of all views considered, including those of the bank representatives. The Invitation to Comment raises questions about hedge ineffectiveness and deposit liabilities.

Introducing the proposals, Sir David Tweedie, IASB Chairman, said:

“A standard on financial instruments is an essential element of any complete set of accounting standards. Implementing IAS 39 certainly poses challenges, but this reflects the fact that derivatives today are complex instruments, and IAS 39 bridges the world of traditional cost accounting and a model that relies more on market values. In these proposals the IASB has listened to and worked closely with its constituents in making a major breakthrough in the area of macro hedging. We will be actively working with interested parties in the months ahead to ensure that we ultimately reach a well-respected, high quality solution.”

The IASB invites comments on the Exposure Draft by 14 November 2003.

The complete text of the Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* is freely available from the IASB Website. From 2 September copies of the Exposure Draft (ISBN 1-904230-31-8) will be available, at £5 each (€8/US\$7) including postage, from the online bookshop or contact: IASCF Publications Department, 1st Floor, 30 Cannon Street, London EC4M 6XH, United Kingdom. Tel: +44 (0)20 7332 2730, Fax: +44 (0)20 7332 2749. Email: publications@iasb.org.uk. Web: www.iasb.org.uk

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NOTES TO EDITORS

In June 2002, the International Accounting Standards Board published an Exposure Draft of proposed improvements to IAS 39 *Financial Instruments: Recognition and Measurement*. It included only limited proposals on the requirements for hedge accounting. In response to the Exposure Draft the IASB received over 170 comment letters. The IASB decided to extend the consultation process and conducted, in March 2003, a series of nine roundtable discussions in which over a hundred organisations and individuals took part. The main issue raised in the comment letters and in the roundtable discussions related to hedge accounting for a portfolio hedge of interest rate risk (sometimes referred to as ‘macro hedging’). The concern was that it is very difficult under IAS 39 to achieve fair value hedge accounting for such a hedge.

In the light of these representations, the IASB decided to explore whether and how IAS 39 might be amended to enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. The IASB’s aim was to develop an approach that:

- (a) complied with the principles that underlie IAS 39 (see below), and
- (b) was workable in practice for entities that manage interest rate risk on a portfolio basis.

The IASB believes that the further amendments to IAS 39 proposed in this Exposure Draft meet these objectives. The hedge accounting approach described in the Exposure Draft resulted, in part, from discussions between a group of Board members and IASB staff and a group of bank representatives. Those discussions did not produce complete agreement, especially on the measurement of hedge ineffectiveness and of deposit liabilities. Under the IASB’s established due process, the Basis for Conclusions includes a discussion of all views considered by the IASB, including those of the bank representatives. The Invitation to Comment raises questions about hedge ineffectiveness and deposit liabilities.

The IASB decided to limit any amendments to applying fair value hedge accounting to a hedge of interest rate risk on a portfolio of items.

The Exposure Draft proposes the following:

1. In a fair value hedge of the interest rate risk associated with a portion of a portfolio of financial assets (or financial liabilities), the hedged item may be designated in terms of an amount of assets (or liabilities) in an expected maturity time period, rather than

as individual assets or liabilities or the overall net position. It also proposes that the entity may hedge a portion of the interest rate risk associated with this designated amount.

2. It proposes that all of the assets (or liabilities) from which the hedged amount is drawn must be items that could have qualified for fair value hedge accounting if they had been designated individually. In the case of financial liabilities included in the balance sheet that a counterparty can redeem on demand (ie demand deposits and some time deposits), the IASB concluded that the fair value of such liabilities is not less than the amount payable on demand and do not change with changes in the interest rate. Including such liabilities (ie demand deposits and some time deposits) in a fair value hedge would imply that its fair value changes with interest rates, which is inconsistent with the IASB's decision. It follows that a financial liability that the counterparty can redeem on demand cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment.
3. The amount of the assets (or liabilities) designated as the hedged item in a maturity time period determines the percentage measure that is used to evaluate hedge effectiveness. Any ineffectiveness is recognised in the profit and loss account.
4. For qualifying fair value hedges, the adjustment arising due to the gain or loss attributable to the hedged item due to a change in the hedged risk may be presented in the following manner:
 - (a) in a separate line item within assets, if the hedged item for a particular maturity time period is an asset, or
 - (b) in a separate line item within liabilities, if the hedged item for a particular maturity time period is a liability.

The separate line items referred to in (a) and (b) above are to be presented in the financial statements next to financial assets or financial liabilities. Amounts contained in these line items will be removed from the balance sheet when the assets or liabilities to which they relate are derecognised.

The principles that underlie IAS 39's requirements for derivatives and hedge accounting

The following is an extract from a paper that was prepared for the roundtable discussions on IAS 39 that were held in March 2003. The full paper is available on the IASB's Website at www.iasb.org.uk.

Principles underlying the ED's requirements – derivatives

- 1 The following principles underlie the ED's requirements for derivatives:
 - (a) Derivative contracts create rights and obligations that meet the definition of assets and liabilities and, as a result, should be recognised.
 - (b) Fair value is the only relevant measurement basis for derivatives, because it is the only method that provides sufficient transparency in the financial statements. The cost of most derivatives is nil or immaterial. Hence if they were to be reported at cost, they would not be included in the balance sheet at all and their success (or otherwise) in reducing risk would not be visible. In addition, the value of derivatives often changes disproportionately in response to market movements (put another way, they are highly leveraged or carry a high level of risk). Fair value is the only measurement basis that can capture this leveraged nature of derivatives—information that is essential to communicate to investors the nature of the rights and obligations inherent in derivatives.

Principles underlying the ED's requirements – hedge accounting

- 2 Hedge accounting allows entities to depart selectively from the normal accounting treatment that would otherwise be applied to the items included in the hedging relationship. In particular, cash flow hedge accounting provides an exception by deferring the recognition in the income statement of derivative gains and losses, whereas fair value hedge accounting provides an exception by accelerating the recognition of gains and losses on the hedged item. Hence hedge accounting principles are needed to provide discipline over the use of hedge accounting. Without such principles, the exceptions noted above would permit a free choice over when to recognise gains and losses. These hedge accounting principles fall into two groups:
 - (a) those that underlie the ED's conditions for when a hedging relationship qualifies for hedge accounting (paragraph 3)

- (b) those that underlie the ED's requirements for the accounting treatment of a qualifying hedging relationship (paragraph 4).
- 3 A hedging relationship should qualify for hedge accounting only when the hedging relationship is:
- (a) clearly defined by designation and documentation;
 - (b) reliably measurable; and
 - (c) actually effective.
- 4 As regards the accounting treatment of a qualifying hedging relationship:
- (a) to the extent that a hedging relationship is not effective, the ineffectiveness is recognised immediately in the income statement.
 - (b) to the extent that a hedging relationship is effective, the offsetting gains and losses on the hedging instrument and the hedged item are recognised in the income statement at the same time.
 - (c) only items that meet the definitions of assets and liabilities are recognised as such in the balance sheet.

About the IASB

The IASB, based in London, began operations in 2001. It is funded by contributions collected by its Trustees, the IASC Foundation, from the major accounting firms, private financial institutions and industrial companies throughout the world, central and development banks, and other international and professional organisations. The 14 IASB members (12 of whom are full-time) reside in nine countries and have a variety of professional backgrounds. The IASB is committed to developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements. In pursuit of this objective, the IASB cooperates with national accounting standard-setters to achieve convergence in accounting standards around the world.

At present, some 35 countries require the use of international standards for all domestic listed companies, six other countries require the use of international standards for some companies, and many countries base their national practices on international standards. In 2002, several jurisdictions, including Australia, the European Union, and Russia, announced that they would require international standards on or before 1 January 2005.