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IFRS 9 Hedge Accounting: Time to early adopt?

The compulsory adoption date for IFRS 9 is rapidly approaching. This new standard has three main parts and it will be mandatory to adopt the financial instruments and impairment sections next year. For hedge accounting, there is a choice between applying IFRS 9 or continuing to apply IAS 39.

Visual Risk has developed considerable expertise and software functionality in applying IFRS 9 for hedge accounting. Several customers have already early adopted with smooth transitions and a range of their auditors have already reviewed our output for the new standard. Many are also using our advanced CVA/DVA calculation engine to satisfy the requirements of IFRS 13, particularly for cross currency swaps.

To assist your planning for IFRS 9 adoption, Visual Risk is publishing several articles. The first will focus on the advantages of early adoption for the coming year and explain some key changes to be aware of. Later articles will include an adoption checklist, an explanation of the different aspects of IFRS 9 including risk management alignment, hedge relationship setup and the transition accounting explained.

If you would like to discuss IFRS 9 with our accounting experts, please contact us directly.

Early adoption: Is it right for you?

Advantages:

• Allows the time value of options to be amortised through P&L or deferred to the maturity of the hedged item. This will usually eliminate P&L volatility for these instruments and make earnings smoother.

• Offers improvements for commodity basis risk. Hedging commodity risk with a similar but related commodity derivative is quite common. Under IAS 39, the entire exposure had to be designated which led to P&L volatility. The new risk component approach in IFRS 9 will usually eliminate this volatility.

• Currency basis and forward points can be treated as a cost of hedging in the same way as option time value. This will simplify the accounting for currency basis and the use of FX swaps where forward points are amortised to interest income or expense.

• Testing of relationships has been simplified and the 'bright line' retrospective dollar offset has been removed. This will be helpful for relationships which are economically sound but statistically may not always pass.

• Allows designation of derivatives or a combination of derivatives and exposures as the hedged item. Not being able to designate a combination of a foreign currency bond and a cross currency swap was often an issue under IAS 39.

The IFRS 9 project has three distinct parts; classification and measurement, impairment and hedge accounting. The first two must be adopted eventually so commencing early will enable better planning for any potential P&L effects or any need to change hedging and risk management policies.

Disadvantages:

•Adoption of part one, classification and measurement, may require changes in the accounting of some financial instruments. The new rules differ in determining which instruments are at fair value through P&L, but for normal debt and investments there is no change.

• The impairment rule is applied to normal financial assets such as loans and investments and will chiefly affect financial institutions. Rather than taking a credit impairment after a credit event, you must recognise a loss allowance for expected credit losses. This requires increased analysis and may lead to increased credit loss reserves.

• Under IFRS 9, the hedge ratio for a hedge relationship must be consistent with the risk management strategy. This may cause an issue where a relationship in IAS 39 has been set up with a hedge ratio designed to achieve the most effective result.

• The hedge accounting for cross currency swaps has changed and may involve some restructuring of hedge relationships. The new standard can make such relationships easier but if they were previously effective under IAS 39, there may be no real benefit in transition and it would still require some effort.

NEXT

IFRS 9 for hedge accounting

The main changes in the new standard are a relaxation of the rules regarding which hedged items qualify for hedge accounting, so anything that was qualified previously should be fine.

For commodity hedges with basis risk, options, cross currency swaps or FX contracts where forward points are excluded, there will be a choice to change the designation to a component of a hedged item.

As noted above, IFRS 9 allows designation of a derivative as the hedged item.

Hedge effectiveness requirements

Under IAS 39, regression analysis was the usual method to determine prospective effectiveness and if the test passed, nothing else was required. The dollar offset test was more problematic on an ongoing basis as this frequently required explanations due to small mismatches causing the ratio to be outside the 'bright line' of 80-125.

Under IFRS 9, there is a bit more setup work to do upfront but, on an ongoing basis, there is no extra requirements other than confirming that the original effectiveness conditions are still satisfied. These conditions are that:

(i) There is an economic relationship between the hedged item and the hedging instrument.

For most relationships, we expect that this will not be difficult. An economic relationship will often be clear if based on some matching critical terms. Many users of systems will continue to use regression analysis as a short cut for this condition, although the standard does state that a regression correlation is not sufficient in all cases.

(ii)The effect of credit risk does not dominate the valuation changes that occur from any market impact on that relationship.

For initial designation, a confirmation that the credit risk of the hedge transaction and of the hedged exposure are low is enough. An example of this condition becoming an issue would be a severe deterioration in the credit standing of a derivative counterparty.

(iii)The hedge ratio of the hedge relationship matches the hedge ratio between the real underlying exposure and real hedge.

Conclusion

There are two key advantages to the new standard for hedge accounting:

1. increased flexibility
2. less onerous testing requirements.

From a designation and testing point of view, there should not be any concerns about transitioning to the new standard. While the other two sections of IFRS 9 might require some extra work (classification and measurement, Impairment) these should be addressed eventually but they should not be a reason not to adopt early.

Importantly, IFRS 9 hedge accounting does seek to strongly align risk management far more closely with hedge accounting. The next article will discuss this crucial risk management connection and some other transition issues.

If you would like to discuss IFRS 9 with our accounting experts, please contact us directly on info@visualrisk.com or +61 2 9262 6969.