



Hedge Accounting under the new Market Conditions

Market conditions and expectations play an important role in applying hedge accounting, and this unprecedented period of market disruption may significantly impact hedging programs. After several years of low volatility and strong economic growth, many companies suddenly face some big changes to their risk profiles and risks for which they were not prepared.

Many existing hedging relationships were established during a time of minimal market volatility, when forecasting future transactions and exposures seemed straight forward. It is important to highlight that the way hedging relationships are documented at inception influences the accounting for the duration of the hedging relationship.

Most companies are likely to be impacted by the market instabilities, either directly or indirectly, and the increased economic uncertainty and risk may have significant financial reporting implications.

In particular, the instabilities may affect a company's risk exposures and how it manages them. Hence if a company applies hedge accounting as part of its management strategy under IAS 39, IFRS 9 or IFRS 102 ("IFRS"), it must carefully consider the effects of the market instabilities on the hedging relationships in place and whether the hedge accounting criteria in IFRS continue to be met. Ongoing changes in the business environment may cause companies to rethink existing risk-management objectives, which will impact existing and future hedging strategies.

The hedge accounting implications will vary depending on each entity's specific circumstances. However, the main impacts are expected to be:

- Changes to the hedged transactions (in timing or amount);
- Hedge effectiveness and ineffectiveness following deterioration of the entity's or counterparty's creditworthiness in uncollateralised derivatives;
- Uncertainty on the recoverability of deferred debit balances;
- Transparent and appropriate disclosures; and
- Market changes impacting certain hedging relationships.



Changes to hedged transactions

A hedged transaction must be defined with sufficient detail so that it is identifiable. This requirement often results in companies designating a specified amount of sales/purchases over a period or interest payments on a specific debt instrument or portfolio.

Due to the market instabilities, a company may need to revisit its portfolios by making changes to items originally designated as hedged items in hedge accounting relationships. For example, airlines that would have designated a highly probable forecast purchase of fuel during the months of April/May may need to designate purchases of fuel in other months. Any modifications to the contractual terms of a financial item may have impacts on the hedging relationship depending on how it is designated.

Changes to the hedged item that were not contemplated in the documentation prepared at inception of the hedging relationship may result in hedge accounting being discontinued (e.g. delayed payments of principal in a loan agreement). In fact, if the main terms of the hedged item are different, the company would need to enter in a new hedging relationship and discontinue the original one causing additional complexity in the effectiveness and ineffectiveness assessment.

Under IFRS 9 "hedge accounting", the new requirements for effectiveness test can be altered because of a portion of the transaction no longer exits. The hedge ratio is defined as the ratio that results from the actual quantities of the hedged item and the hedging instrument used.

A hedging relationship may fail to meet the hedge effectiveness requirement regarding the hedge ratio as the hedge ratio may no longer represent what is used for risk management purposes.

If the entity's risk management objective for that designated hedging relationship has remained the same, the entity may adjust the hedge ratio so that it meets the qualifying criteria again. By adjusting the hedge ratio, an entity compensates for changes in the relationship between the hedging instrument and the hedged item arising from the underlying or risk variables. This adjustment allows an entity to continue the hedging relationship when the relationship between the hedging instrument and the hedged item changes in a way that can be compensated for by adjusting the hedge ratio. If the risk management objective for the designated hedging relationship has changed, then rebalancing does not apply. Instead, hedge accounting is discontinued.

Fair Value Hedges

For a fair value hedge, companies that are hedging firm commitments should assess whether recent economic events have impacted their assessment of whether performance is still a firm commitment. If the hedged item later ceases to meet the definition of a firm commitment, the hedge relationship is discontinued and any gain or loss resulting from the hedge relationship is recognised in earnings immediately.

Cash Flow Hedges

For a cash flow hedge, uncertainty on designated forecast transactions may affect its eligibility as a hedged item. In order to be an eligible hedged item, the forecast transactions should be highly probable and should present an exposure to variations in cash flows that could ultimately affect profit or loss. The assessment of whether the transaction is highly probable needs to reflect the expectations at the reporting date. If the market instabilities reduce the probability of the hedged item occurring or affect its timing, then hedge accounting may need to be terminated.

If a forecast transaction is no longer highly probable, a reporting entity must discontinue hedge accounting. However, the accounting implications differ on whether the transaction is still expected to occur:

- Still expected to occur: the net cumulative gain or loss that was recognised in OCI during the effective period of the hedge remains in equity until the expected transaction occurs.
- No longer expected to occur: the related cumulative gain or loss on the hedging instrument that was recognised in OCI is immediately reclassified to profit or loss.

IFRS 9 does not specify a timeframe in which the forecast transaction should occur, it should be expected to occur within a reasonably specific and narrow range of time. Some delay in the occurrence of a highly probable forecast transaction is acceptable so long as the transaction is considered to be the same forecast transaction. In any case the actual time period is always determined on a case-by-case basis and will involve some degree of judgement.

Debt Restructuring

Economic disruption during this period of market instability has caused financial burdens for many borrowers. Governments might also encourage banks to provide

concessions for particular types of customers. When debt terms are renegotiated, borrowers will need to analyse these arrangements carefully to determine the appropriate accounting.

Examples of modifications during a restructuring of a debt designated as hedged item might be a change in the maturity date, delay in payments or change in the underlying benchmark index. Any modifications to the contractual terms of a financial item may have impacts on the hedging relationship depending on how it is designated.

If the documentation envisaged modifications of the hedged item that is designated as a specific loan and therefore allows the hedging relationship to continue, the hedged item would reflect its new terms which may give rise to ineffectiveness recognised in the profit or loss.

If the impact of the debt restructuring is to discontinue hedge accounting as the hedged item and consequently also the hedging relationship have changed, a company's choices are to

- Designate the restructured hedged item with the same hedging instrument in a new hedging relationship; or
- Designate the restructured hedged item with a new hedging instrument that matches its term, terminating the old derivative previously designated.

Beginning a new hedging relationship with an existing hedging instrument that has a fair value other than zero is likely to result in hedge ineffectiveness. This is because the initial fair value of the instrument is itself subject to change with market changes. Unless an offsetting fair value effect is also present in the hedged item, hedge ineffectiveness will result.





Hedge effectiveness and ineffectiveness

One of the main requirements to apply hedge accounting is that a reporting entity must expect the hedge to be highly effective. The market instabilities have caused drastic changes in many variables simultaneously. For instance, counterparty risk and own credit risk which are factors to consider while assessing hedge effectiveness and measuring hedge ineffectiveness may have deteriorated.

The fair value changes of a derivative reflect the present value effect of the relative credit risks of the counterparties to the relationship. This is because the effect of the counterparties credit risks are reflected in its fair value (XVA adjustments).

An entity also considers the nature of the hedged item in determining whether the hedged item has any credit risk. For example, in a fair value hedge of inventory there is no credit risk on the hedged item. Conversely, credit risk may exist in a cash flow hedge of a forecast sale of inventory.

Therefore, fair value changes of the hedging instruments and hedged items may not be able to be offset due to an increase in the credit risk of the hedging instrument. This could lead to increased ineffectiveness and the potential to fail the effectiveness assessment.

While the standards IAS 39 and FRS 102 detail a specific range for the offset ratio between the hedged item and hedging instrument outside of which the relationship is considered to be not effective (80%-125%), IFRS 9 does not provide specific guidance on how to determine whether the effect of credit risk dominates the change in fair value. As a result even though ineffectiveness is measured by each of the standards, companies applying the new standard will have more flexibility in concluding on the effectiveness of the hedging relationships.

Companies applying hedge accounting must assess effectiveness of the hedging relationship based on the requirements of the standard. A qualitative methodology is appropriate (i.e. IAS 39 prospective test and IFRS 9 economic relationship) when a company can reasonably support an expectation of high effectiveness. However, following changes in facts and circumstances caused by recent economic events, companies should closely review the methodologies applied as they might not be able to support that expectation without performing a quantitative assessment.

In a cash flow hedge, the credit risk on the hedged item may also affect the assessment of whether the forecast transaction is highly probable.



Irrecoverable losses in Cash Flow Hedge reserve

The market instabilities may have increased the risk of irrecoverability of debit balances in the cash flow hedge reserve. For instance, a company hedging future purchases of inventory may not recover a loss on the hedging instrument through expected sales of those items; or a company hedging the purchase of a fixed-rate financial

asset may not recover a loss on the hedging instrument because the financial asset has become credit-impaired.

If the company has evaluated all or a portion of the accumulated loss in its cash flow hedge reserve as not recoverable in future periods, then it would need to immediately reclassify the amount that is not expected to be recovered to profit or loss.



Disclosures

When a company applies hedge accounting, it is required to disclose how it applies its risk management strategy and the effects on its financial performance and future cash flows.

It is likely that the market instabilities will affect these disclosures following the impacts outlined above and on possible changes in how the company manages risks. Hence, companies will need to use judgement to determine the specific disclosures that are relevant and necessary for its business.



Market changes impact

While the considerations above are applicable broadly across most hedging relationships, there are several complexities that could arise in hedging relationships that are not considered to be a "plain vanilla" hedging relationship.

Portfolio hedges of similar assets or liabilities

Companies may enter into hedges of an aggregated portfolio of similar exposures. For these hedging relationships, companies must demonstrate at inception and on an ongoing basis that its portfolio of assets or liabilities respond in a proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk, that is, they continue to be considered similar. Consider, for example, a portfolio hedge of jet fuel where purchases are based on the negotiated index or pricing at each location. Individual hedged items within the portfolio may be impacted by different market forces and, therefore, may not respond proportionally to the portfolio as a whole, thus the portfolio will no longer be considered an eligible hedged item. It would be inappropriate to continue to apply hedge accounting, for example, if it were expected over the course of the next hedge assessment period that the portfolio would not continue to move in a similar fashion as a consequence of market factors.

Interest rate floors embedded in the hedged transaction

Hedge relationships that involve credit facilities or other debt instruments containing a LIBOR floor and an interest rate swap that does not contain a mirror-image floor may experience lowered effectiveness as a result of declining interest rates as the floor gains value. For example, many credit facilities contain a zero percent floor on the floating rate benchmark. Companies should take inventory of the

interest rate floors included in their credit facilities that are subject to a hedge of interest rate risk. Further, many companies have previously used a qualitative assessment that the floor has an immaterial impact on the hedging relationship. These companies may now be required to quantitatively assess effectiveness should that assertion no longer be supportable.

De-designation and re-designation of a combination of options

Interest rate collars are a common strategy for managing upside and downside interest rate or commodity price risk simultaneously. These instruments are comprised of a purchased option and written option that at inception is a net zero fair value option or a net purchased option, which is an important consideration in qualifying for hedge accounting. If the hedging relationship is required to be de-designated due to changes in a company's hedged exposures, a company may wish to re-designate the collar in a new hedging relationship. However, if the fair value of the written option exceeds the value of the purchased option, the collar now represents a net written option that would preclude designation in a new hedge relationship. Special care should be taken when re-designating hedge relationships involving a combination of options to determine whether they represent an eligible hedging instrument.

Layers of forecasted transactions when using multiple hedging instruments

Many companies apply a layering approach to identify hedged forecasted transactions, which may result in complexities if shortfalls of forecasted transactions occur. Usually several derivatives are executed and designated in separate hedging relationships to hedge a series of forecast transactions. Consider a scenario where a company hedges €250 million of forecasted quarterly foreign currency purchases with two derivative instruments. If purchases of only €150 million are considered probable to occur, the entity is required to reclassify amounts from OCI into earnings for €100 million of forecasted transactions if those transactions are considered probable of not occurring in the period specified. The company will need to determine how this change in forecasted transactions impacts its hedging relationship, such as whether the initial derivative instrument needs to be de-designated and re-designated and whether other derivatives need to have a different priority within the overall hedging program.

Management Actions

- Reassess the reasonableness of their evaluation of whether forecast transactions designated as hedged items in cash flow hedges continue to be highly probable. If a forecast transaction for which amounts remain in the cash flow hedge reserve is not highly probable, then assess the reasonableness of a client's evaluation of whether it is still expected to occur.
- Re-evaluate their assessment of whether accumulated losses in the cash flow hedge reserve will be recovered in future periods.
- Re-evaluate their determination of whether any changes in the contractual terms of a hedged financial instrument resulting from the market instabilities affect the instrument's eligibility to be a hedged item.
- Re-evaluate whether changes in the credit risk of hedging instruments and hedged items arising from the market instabilities are appropriately reflected in the assessment of hedge effectiveness and the measurement of hedge ineffectiveness.
- Re-evaluate their assessment as to whether accumulated losses in the cash flow hedge reserve are recoverable.
- Re-assess whether they have disclosed the significant impacts of the market instabilities on the risks arising from its financial instruments, including how it is managing those risks.
- Whether management has adequately disclosed the following:
 - Any changes in how the client manages risks which impact on its hedge accounting;
 - The impacts of the market instabilities which result in hedge ineffectiveness;
 - Forecast transactions that were subject to hedge accounting but are no longer expected to occur and the related reclassifications to profit or loss; and
 - Reclassifications of irrecoverable losses from the cash flow hedge reserve to profit or loss.

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