U.S. GAAP & IFRS: Today and Tomorrow
Sept. 13-14, 2010

New York

Financial Instruments

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Society of Actuaries

US GAAP Seminar

Financial Instruments

Joint Project

September 14, 2010

*connectedthinking

Agenda

- Setting the stage
- Classification and measurement
- Impairment and interest recognition
- Hedge accounting

"Portions of FASB Proposed Accounting Standards Update – Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities, copyright © by Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, are reproduced by permission."

Setting the Stage

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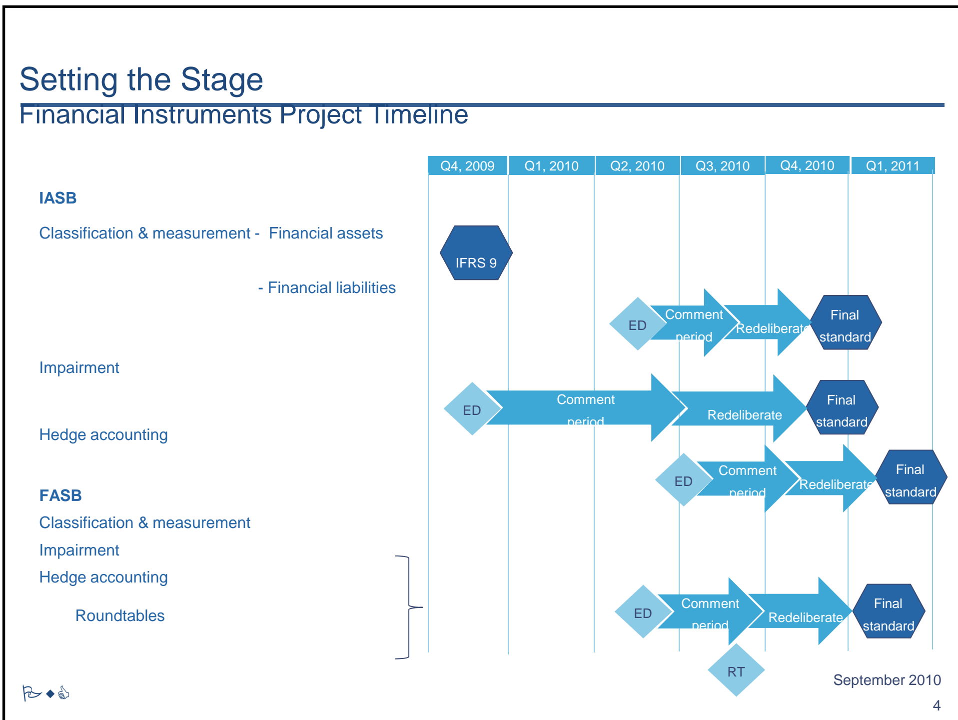

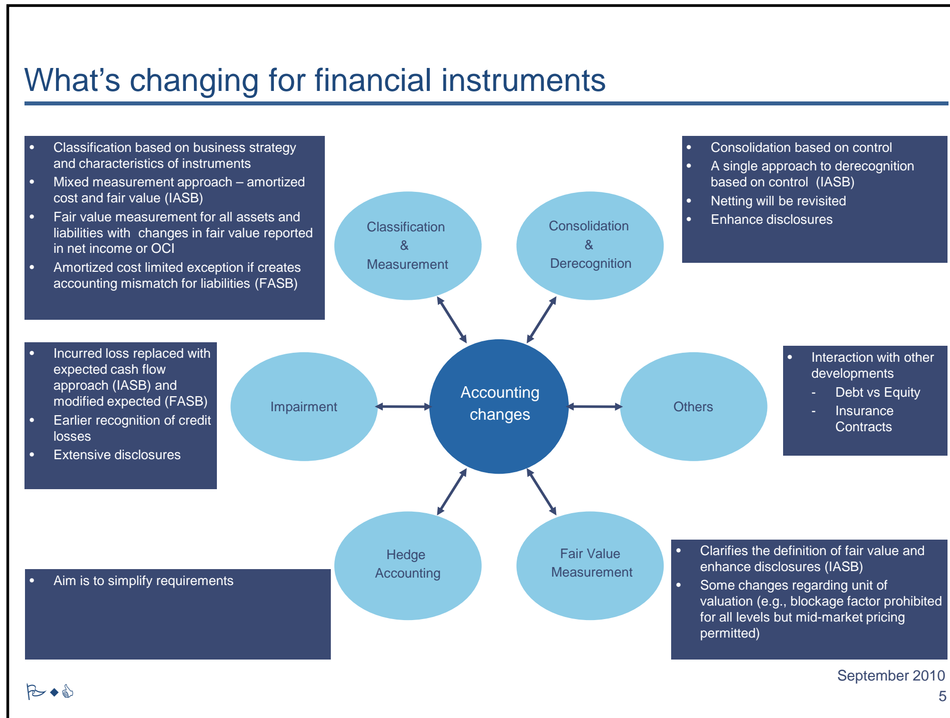
What's changing for financial instruments
Classification based on business strategy and characteristics of instruments
Mixed measurement approach – amortized cost and fair value (IASB)
Fair value measurement for all assets and liabilities with changes in fair value reported in net income or OCI
Amortized cost limited exception if creates accounting mismatch for liabilities (FASB)
Consolidation based on control
A single approach to derecognition based on control (IASB)
Netting will be revisited
Enhance disclosures
Classification & Measurement
Consolidation & Derecognition
Incurred loss replaced with expected cash flow approach (IASB) and modified expected (FASB)
Earlier recognition of credit losses
Extensive disclosures
Impairment
Accounting changes
Others
Interaction with other developments
- Debt vs Equity
- Insurance Contracts
Hedge Accounting
Fair Value Measurement
Aim is to simplify requirements
Clarifies the definition of fair value and enhance disclosures (IASB)
Some changes regarding unit of valuation (e.g., blockage factor prohibited for all levels but mid-market pricing permitted)
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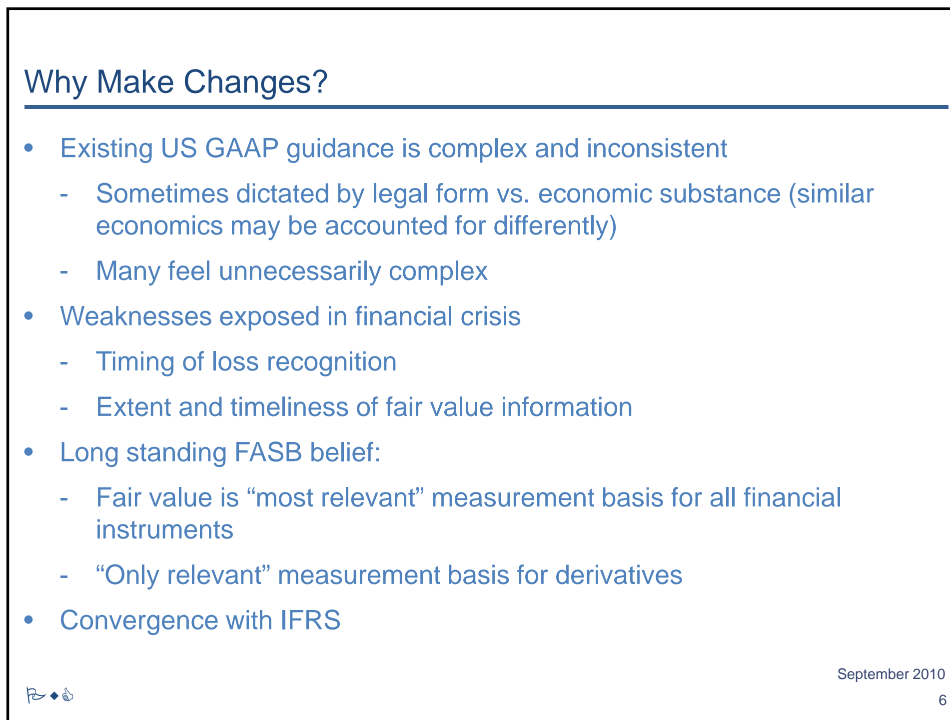
Why Make Changes?
Existing US GAAP guidance is complex and inconsistent
- Sometimes dictated by legal form vs. economic substance (similar economics may be accounted for differently)
- Many feel unnecessarily complex
Weaknesses exposed in financial crisis
- Timing of loss recognition
- Extent and timeliness of fair value information
Long standing FASB belief:
- Fair value is "most relevant" measurement basis for all financial instruments
- "Only relevant" measurement basis for derivatives
Convergence with IFRS
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FASB Support of Fair Value on Balance Sheet

- Fair value
  - Little argument regarding trading items (carry at FV)
  - Even if no intent to sell
    - FV shows results if required to sell (factors outside control)
    - FV shows impact of decisions not made (opportunity cost)
    - FV improves comparability by removing management intent
- Fair value vs. amortized cost
  - Both have relevance, thus FASB presents both on face of F/S
  - Income statement reflects "business strategy" if applicable
- Timing and location
  - FV information available at time of earnings releases
  - Face of financial statement vs. notes
- Regulators – continue to have information necessary for regulatory capital using either FV or amortized cost, of so desired

Convergence?

The FASB's main objective is to develop accounting standards that represent an improvement to U.S. financial reporting. What may be considered an improvement in jurisdictions with less developed financial reporting systems applying International Financial Reporting Standards (IFRS) may not be considered an improvement in the United States.

(Excerpt from proposed ASU, *Accounting for Financial instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*)

One response…

Dear Sirs:

Theoretically arrogant; in practice insane; financially negligent and reckless.

Other than that, I have no concerns.

Sincerely,

James C. Blaine

President

State Employees Credit Union

High Level summary of FASB and IASB models

- Classification and measurement
  - Both the IASB and FASB support a two-bucket approach, however…
  - The buckets are not the same. The IASB prefers a mixed measurement approach (amortized cost and fair value) while the FASB prefers fair value measurement for balance sheet recognition of all financial instruments
  - Both boards have similar classification criteria – based on business strategy and instrument characteristics
- Impairment
  - The IASB prefers an expected loss approach while FASB prefers an modified expected loss approach
- Hedge accounting
  - Both boards support hedges of risk components of financial instruments being eligible for hedge accounting

Classification and Measurement

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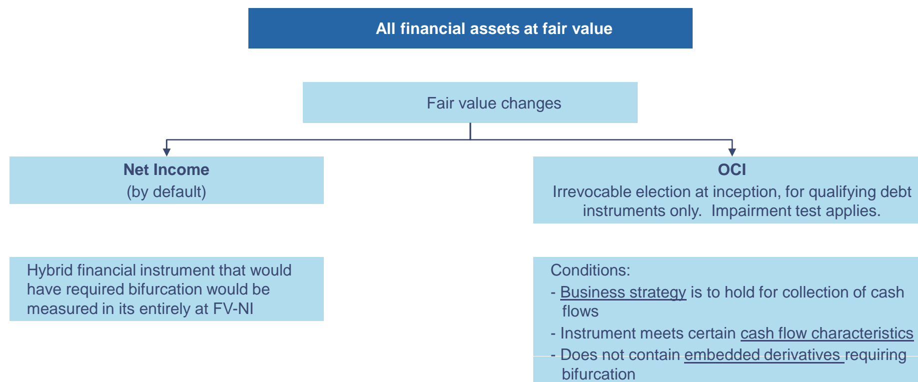
Financial assets - Overview



IASB approach: mixed measurement model (fair value or amortized cost) under IFRS 9 which is different from the FASB proposal where all financial assets are at fair value, with changes in net income or OCI.
IFRS 9 also eliminates embedded derivative bifurcation analysis for financial assets (i.e. the classification is determined based on the entire instrument).

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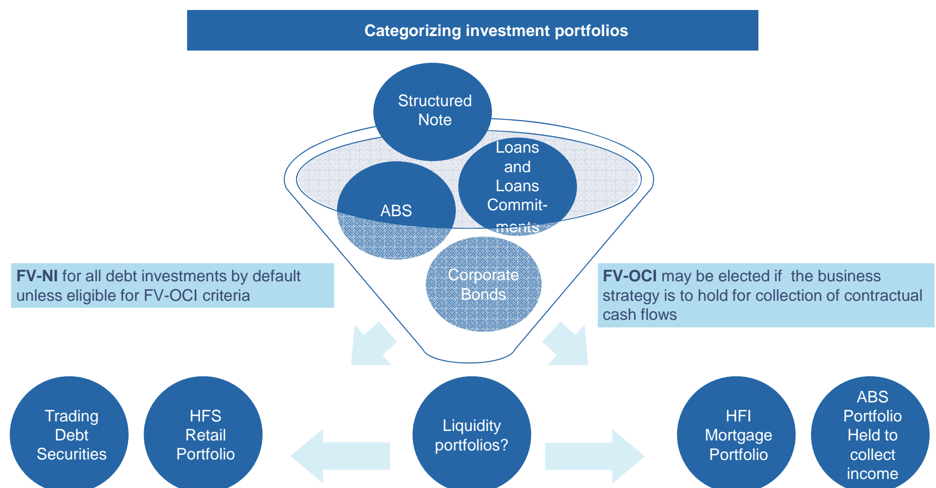
Debt Instrument

A receivable or payable that represents a contractual right to receive cash (or other consideration) or a contractual obligation to pay cash (or other consideration) on fixed or determinable dates, whether or not there is any stated provision for interest. (Proposed ASU definition)

- No distinction between debt "securities," loans, beneficial interests, etc.
- Results in consistent application of guidance to similar instruments, regardless of legal form
- Only debt instruments may be classified as FV OCI

Debt Instruments – Business strategy test



Debt Instruments – Conditions to elect FV-OCI
Business strategy test

Hold the financial instruments for collection of contractual cash flows rather than to sell or settle

- Based on how an entity manages its financial instruments on a portfolio basis, rather than on intent related to an individual instrument
- Need to demonstrate that instruments in a portfolio designated as held for collection of contractual cash flows are held for a significant portion of their contractual term
- Need not be determined on a reporting entity level
- Can have more than one business strategy for managing the same type of financial instrument
- No tainting but prospective change on newly acquired financial instruments; reclassifications from period to period between classification categories are prohibited
- Prepayment (e.g. embedded call or put option) does not prohibit assertion of holding for collection of contractual cash flows

Debt Instruments – Conditions to elect FV-OCI (continued)

Do the below situations meet the business strategy test?

	IASB	FASB
An insurer may adjust its investment portfolio to reflect a change in expected duration (i.e. expected timing of claims payouts)	Yes	It depends
An entity may sell financial assets to fund capital expenditures	Yes	It depends
An entity may sell a financial asset that no longer meets the entity's investment policy (e.g. credit rating of the asset declines below that required by the entity's investment policy)	Yes	Possibly yes
An entity actively manages a portfolio of assets in order to realize fair value changes arising from changes in credit spreads and yield curves	No	No

IFRS 9 provides some examples of when sales are permitted under the business model test. FASB is silent on those situations. Based on current wording of the proposed guidance, IFRS 9 seems to provide more flexibility.

Debt Instruments – Conditions to elect FV-OCI (continued)

Do the below situations meet the business strategy test?

	IASB	FASB
A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis	**No**	**No**
An entity's business strategy is to purchase portfolios of financial assets, such as loans with incurred losses, and for collection of contractual cash flows	**Yes**	**Yes**

Debt Instruments – Conditions to elect FV-OCI (continued)
Cash flow characteristics

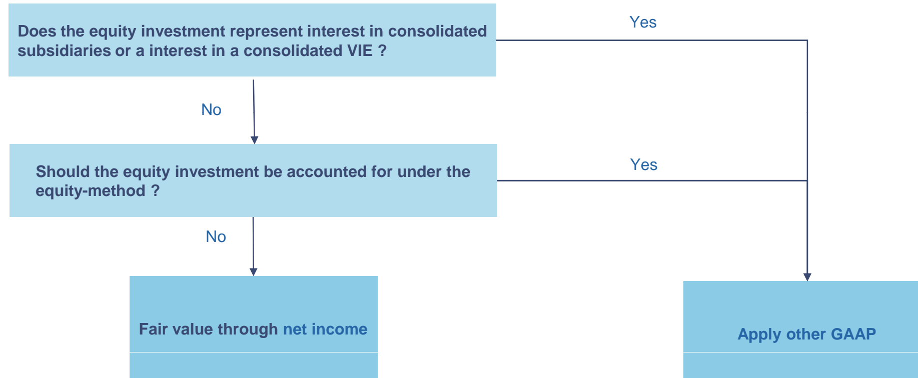
Characteristics	Examples
a) Upfront transfer of funds at inception (principal amount adjusted by any original issue discount or premium) that will be returned at maturity or settlement	Two-way transfer of funds at inception fails (e.g., principal exchange at inception of a cross-currency swap)
b) Contractual terms identify any additional contractual cash flows to be paid to the creditor either periodically or at the end of the instrument's term	Fixed or variable interests pass Return does not necessarily have to be computed on the basis of the application of a rate or index to a principal (e.g. principal-only strip or zero coupon bond could meet this characteristic)
c) Cannot be contractually prepaid/settled so that an investor would not recover substantially all of its initial investment	Investor performs assessment at acquisition date Pre-payable interest-only strips fail

Debt Instruments – Cash flow characteristics test for financial assets

Common financial instruments	Measurement
Zero coupon bond	FV-OCI
Bonds with typical interest rate cap or floor	FV-OCI
Pre-payable interest-only strips	FV-NI
Non-prepayable interest-only strips	FV-OCI
Principal-only strips purchased at par	FV-OCI
Debt investments purchased at a substantial premium over the amount at which they can be prepaid	FV-NI
Inverse floater note with interest rate floor (assuming no embedded requiring separation)	FV-OCI
Convertible bonds (investor)	FV-NI
Credit linked note or synthetic CDO	FV-NI
30 day commercial paper/repo	FV-OCI
Loan commitments for HFI mortgage portfolio	FV-OCI
Standby letter of credit for a commercial customer (assumes when drawn, will hold)	FV-OCI
Originated/purchased HFI loans with fixed or variable interest rate	FV-OCI
Originated/purchased HFS conventional mortgages	FV-NI

- It is assumed that the business strategy test is met for all of the above instruments
- It is assumed that all embedded derivatives are closely and clearly related for all of the above instruments except for convertible bonds and credit linked notes or synthetic CDOs
- Any debt investment at FV-OCI is subject to impairment

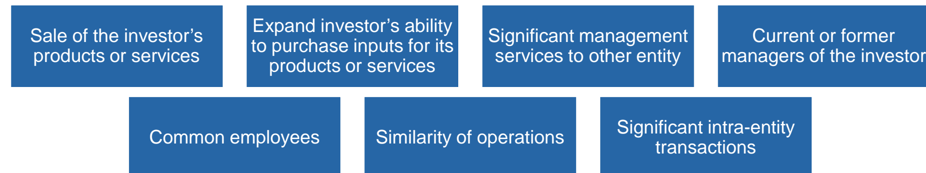
Equity investments



IFRS 9 provides limited FV-OCI option for non-trading equity investments. Gains and losses recognized in OCI are not recycled

Equity method of accounting

- An investor applies equity method of accounting if (1) it has significant influence over the investee and (2) the operations of the investee are considered related to the investor's consolidated operations.
- The following factors, which are not all inclusive, should be evaluated to determine if the operations of the investee are considered related to the investor's consolidated operations:



IAS 28 requires equity investments over which the investor has significant influence to be accounted for using the equity method regardless of whether the investee is considered related to the investor's consolidated operations, though fair value option available for investment companies.

- No one single factor that necessarily carries any more weight than the others.
- FVO no longer available for investments accounted for under the equity method.

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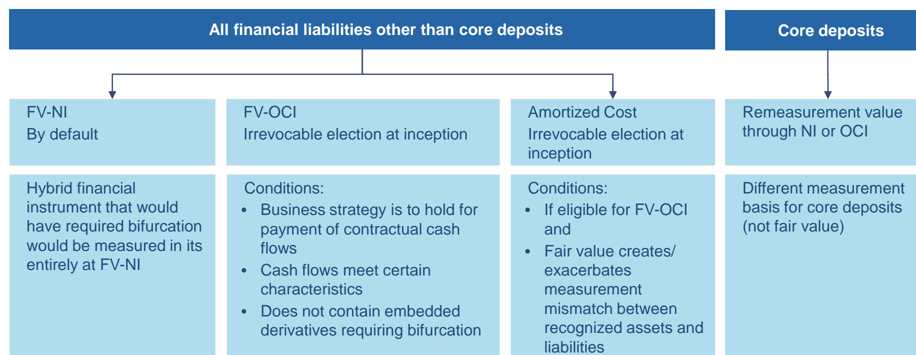
Financial liabilities – Overview



IASB tentatively decided financial liabilities must be subsequently measured at amortized cost if they are not held for trading (unless the FVO is elected). Embedded derivatives are separated from a liability host and accounted for as derivatives if particular conditions are met. When the fair value option is elected, changes in own credit risk will be recognized in OCI and not recycled, even upon derecognition of the liability.

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Other liabilities – Amortized cost election

Measurement of a financial liability at fair value would be deemed to create or exacerbate a measurement attribute mismatch only if at least one of the following criteria apply:

- The financial liability is contractually linked to an asset not measured at fair value. For example, the liability is collateralized by an asset, or that is contractually required to be settled upon the derecognition of an asset measured at amortized cost
- The financial liability is issued by and recorded in, or evaluated by the chief operating decision-maker as part of, an operating segment for which less than 50% of the segment's recognized assets[1] are subsequently measuredat fair value
- The financial liability does not meet item (a) or (b) above but is the liability of a consolidated entity for which less than 50% of consolidated recognized assets[1] are subsequently measured at fair value
- The financial liability does not meet item (a) or (b) above but is the liability of a consolidated entity for which less than 50% of consolidated recognized assets[1] are subsequently measured at fair value

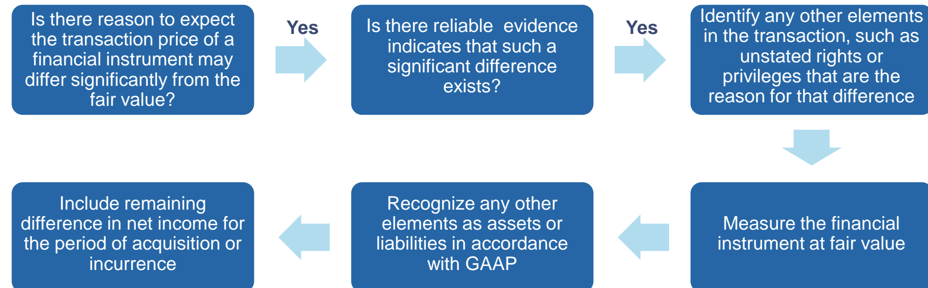
[1] Recognized assets represent assets recognized as of the end of the immediately preceding reporting period (less assets that are contractually linked to a financial liability), plus any assets acquired by issuing the financial liability. Cash (exclusive of cash equivalents) is not considered to be measured at fair value for purposes of applying the quantitative test.

Other features of the model

- No bifurcation of embedded derivatives (that would have required bifurcation) for instruments within the financial assets and financial liabilities model (refer to separate bifurcation guidance for financial instruments with characteristics of equity project)
- FV-OCI and amortized cost election is made when the asset/liability is acquired/issued and is irrevocable
- Open-ended fair value option not applicable as default is FV-NI
- Reclassifications prohibited
- Fair value option not available for investments accounted for under the equity method
- Gains/losses in OCI reclassified into income statement upon sale or settlement
- For FV-NI instruments, transaction costs will be expensed rather than included in the basis with an immediate unrealized loss

Tax consideration: where tax methodology for financial assets is not mark-to-market, the proposed fair value model (through NI or OCI) will generally create or exacerbate book-tax differences; liabilities generally cannot be marked-to-market for tax and as a result book-tax differences will also be created or exacerbated by the change.

Other features of the model (continued)
Transaction price differs significantly from fair value (FV-OCI)



Examples include loans offered with "teaser" rates or other off-market or zero interest rates. Under current US GAAP, no P&L will be recognized on day 1 but lower yield will be recognized over the life. Under the proposed model, a day 1 loss may be recognized at inception and higher yield may be recognized over the life.

There will be implementation issues in inventorying all transactions that could be "off market" and determining if the difference is "significant"

Comparison – Current versus proposed

	FASB, current	FASB, proposed
Balance Sheet	• Financial assets: - Fair value through net income (FV-NI), fair value through other comprehensive income (FV-OCI) or amortized cost • Financial liabilities: - Fair value option or amortized cost	• Financial assets: - All at FV-NI or FV-OCI • Financial liabilities: - FV-NI or FV-OCI - Limited amortized cost exception if certain conditions are met - Remeasurement value for core deposits
Income Statement	• Fair value gains/losses from trading securities and financial instruments accounted for under the fair value option	• Fair value gains/losses from all financial instruments classified at FV-NI
Scope	• Investor with significant influence applies equity method of accounting • Certain loan commitments are excluded	• Equity method only applies if investor has significant influence and the operations of investee are related to the investor's consolidated operations • All written loan commitments, except credit card commitments are in scope (i.e., will be at fair value with changes either in OCI or NI)
Initial measurement	• Limited fair value requirement	• For instruments carried at FV-OCI, fair value required if significantly different from transaction price

US GAAP versus IFRS – Comparison

	FASB proposal	IFRS 9
Loans held for investment and debt securities held to maturity	FV-OCI	Amortized cost if "vanilla" features
Debt securities available for sale	Some at FV-OCI and others at FV-NI	Some at amortized cost and others at FVTPL
Hybrid financial assets (e.g. structured investments)	FV-NI (lower tranches) Some higher tranches may be eligible for FV-OCI provided that the cash flow characteristic criterion is met and that there are no embedded derivatives that would require bifurcation	FVTPL (lower tranches) Some higher tranches may qualify for amortized cost
Convertible debt (based on current FICE model)	Instruments within the scope of FSP APB 14-1/ASC 470-20 – separate into equity and liability components; liability may be FV-NI, FV-OCI or amortized cost) Instruments outside the scope of FSP APB 14-1/ASC 470-20 – FV-NI for entire hybrid	If conversion option meets equity definition, separates conversion option and account for as equity; liability host is measured at amortized cost. If conversion option fails equity definition, separates conversion option and account for as derivative; liability host is measured at amortized cost

US GAAP versus IFRS – Comparison (continued)

	FASB proposal	IFRS 9
Equity instruments	FV-NI Equity method limited to when the investor (1) has significant influence and (2) investee's business is related to consolidated business	FVTPL if held for trading If not held for trading, an entity may elect FVTOCI Equity method if significant influence -> more investments allowed under equity method
Short term receivables	Amortized cost (subject to impairment) if due within one year and business strategy is to hold for collection/payment	Amortized cost or FVTPL depending on business model and instrument characteristics
Own debt	FV-OCI or FV-NI Own credit separately disclosed Option to use amortized cost	Amortized cost if non-trading or hybrid instrument with not closely related embeddeds For non-trading hybrid instrument with not closely related embeddeds, host at amortized cost and bifurcate embedded derivative If elect fair value option, then fair value due to own credit recognized in OCI Gains and losses attributable to changes in own credit risk recognized in OCI will not be recycled

US GAAP versus IFRS – Comparison (continued)

	FASB proposal	IFRS 9
Structured debt	FV-NI	Amortized cost for host contract if held for payment of contractual cash flows with embedded features separately recognized at FVTPL
Bank core deposit liabilities	Remeasured based on a present value calculation with changes reflected in OCI	Face amount/payable amount
Derivatives	FV-NI unless in a hedging relationship	FVTPL unless in a hedging relationship
Short term payables	Amortized cost if due within one year and business strategy is to hold for collection/payment	Amortized cost if not held for trading

Financial statement profile for an insurance company

Assets				Liabilities			
	IASB *	FASB **			FASB **	IASB *	
B/S >>	FV	FV	Trading	Insurance liabilities	TBD	TBD	<< B/S
Changes>>	P&L	P&L			TBD	TBD	<< Changes
			Liquidity				
B/S >>	Mixed	FV					
Changes>>	Mixed	P&L or OCI					
	Structured debt investment = FVTPL		Assets backing Insurance Liabilities				
B/S >>	Amort cost	Fair value	Debt				
Changes>>	n/a	P&L or OCI					
B/S >>	FV	FV	Equity	Debt ^	Fair value	Amort cost	<< B/S
Changes>>	OCI or P&L	P&L			OCI	n/a	<< Changes
B/S >>	FV	FV	Strategic equities				
Changes>>	OCI	P&L					
B/S >>	Equity	FV	Equity Investments*				
Changes>>	Method	P&L					
			Non-financial assets	Equity			

Structured debt issued:
-FASB = FVTPL
-IASB = bifurcate embedded or elect fair value option

* Equity investments where investor has significant influence over the investee but the operations of the investee are NOT considered related to the investor's consolidated operations.
^ Includes investment contracts and contracts accounted for under the deposit method

Impairment and interest recognition

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Why is the model changing

- Criticisms of the current impairment model
  - Different models depending on the type of instrument (loans vs. debt securities)
  - Different models depending on whether a security is required to be sold/more likely than not will be sold vs. does not expect to recover amortized cost
  - The existing impairment model for loans does not permit timely recognition of credit impairments
  - Interest income is recognized on principal that is not expected to be collected
- Objectives
  - Create a single impairment model for financial assets
  - Recognize credit impairment when an entity does not expect to collect all amounts due according to the contractual terms
  - Recognize interest income based on cash flows that an entity expects to collect

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Overview of FASB model

- Recognize interest income based on the cash flows an entity expects to collect

Effective interest rate is the implicit rate of return

Contractual interest adjusted for fees and costs, premiums and discounts (for originated assets and assets acquired at a discount that does not relate to credit quality)

Net carrying amount (before fair value adjustment)

Gross balance (net of write-offs) **less allowance**

Interest income = EIR x (gross balance less allowance)

- In subsequent periods…
  - If contractual interest due is greater than interest income, the excess credited to allowance
  - If allowance exceeds expected losses, the difference is recognized as a recovery rather than as additional interest income

Tax consideration: the proposed model for interest recognition will generally result in unfavorable book-tax differences (phantom income); interest income recognition for tax generally based on contractual rate and principal.

Overview of FASB model

- **Recognize** credit impairment in net income for a financial asset when an entity does not expect to collect all amounts due according to the contractual terms of the financial asset.

- Both contractual interest and principal (for originated assets and assets acquired at a discount that does not relate to credit quality)

- No probability threshold
- Based on past events and present conditions and their implications on future collectability
- Historical loss experience for similar assets are considered past events
- Future scenarios not considered

Tax consideration: where tax methodology is not mark-to-market, this proposed impairment model will generally create or exacerbate book-tax differences; often unfavorably. “Bad debt” expense under tax generally recognized based on charge-offs rather than a reserve method.

Overview of FASB model

- Credit impairment is **measured** as the amount of contractual interest cash flows and/or contractual principal cash flows the entity does not expect to collect

Judgment in estimates and latitude in measurement methods

Pools = aggregate loss rate method
Allowance = Principal x PD x LGD

Individual = present value method
Carrying amount = estimated cash flows discounted at original rate

Debt Security – FASB Model Interest Income & Impairment

- Some changes include:
  - Recognizing impairment even when FV > cost
  - Pooling for evaluation of impairment
  - Recording allowance for impairment
- Assume a security is acquired for $100,000 with coupon of 12% due in 6 years
  - End of year 1 = year 1 cash flows collected, FV is $100,000, no change in conditions
  - End of year 2 = year 1 cash flows collected, however conditions change such that the issuer's credit quality has deteriorated and the **expectations of cash flows for the remaining life are**

Year >	1	2	3	4	5	6
Contractual cash flows	12,000	12,000	12,000	12,000	12,000	112,000
Fair value	100,000	75,000	72,000	72,000	75,000	76,397
Change in cash flows (yr 3)	Paid	Paid	12,000	12,000	12,000	88,400
Discount factor using EIR			0.89	0.80	0.71	0.64
Present value			10,714	9,566	8,541	56,180
Sum of PV at end Yr 2		85,000				

- The present value of the revised cash flows at the original EIR is $85,000
- The fair value is $75,000

Debt Security – FASB Model Interest Income & Impairment (cont.)

- Results over the life of the debt security:

Year >	1	2	3	4	5	6
Income statement						
Interest income	12,000	12,000	10,200	9,984	9,742	9,471
(Provision) / recovery	-	(15,000)	-	-	-	-
Balance sheet						
Debt security	100,000	100,000	100,000	100,000	100,000	100,000
less: Allowance	-	(15,000)	(16,800)	(18,816)	(21,074)	(23,603)
Adjustment to FV	-	(10,000)	(11,200)	(9,184)	(3,926)	-
Fair value	100,000	75,000	72,000	72,000	75,000	76,397
Equity - OCI gain/(loss)	-	(10,000)	(11,200)	(9,184)	(3,926)	-

1. Impairment charge taken when credit deterioration occurs based on the best estimate of expected cash flows discounted at the original EIR
2. Interest income calculated based on the gross debt security balance less allowance
3. The adjustment to fair value reflects the non-credit component; users can use this forward looking information to assess the adequacy of the provision
4. The net amount ($76,400 rounded) plus the cash interest received ($12,000) equals the revised expectation of cash flows at maturity ($88,400)

Debt Security – IASB Model Interest Income & Impairment No Change in Loss Expectations

Assumptions:

- Originated loans, pool basis of accounting, closed portfolio
- Initial expectation of losses does not change and reflects actual losses
- Loans charged off in year of actual loss

Pool		10,000				
Contractual rate		10.0%				
Maturity (years)		5				
Year >		1	2	3	4	5
Annual loss rate		0.0%	6.0%	4.0%	2.0%	0.0%
Cumulative loss rate		0.0%	6.0%	9.8%	11.6%	11.6%

Effective interest rate:

- Solve for the EIR that equates the expected cash flows to original loan balance
- Use this rate to calculate catch-up adjustments when cash flow expectations change

Year >		1	2	3	4	5
Expected CF		1,000	970	921	893	9,728
EIR	7.4%					
Discount factor		0.93	0.87	0.81	0.75	0.70
PV of ECF		931	841	744	672	6,812
Total	10,000					

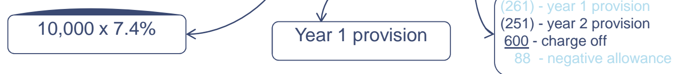
The difference between the contractual rate of 10% and the EIR of 7.4% reflects the inherent return over the life of the pool, regardless of timing of characterization of cash flows as principal or interest

Debt Security – IASB Model Interest Income & Impairment No Change in Loss Expectations (cont.)

Result:

- Initial expected losses are spread over the life of the loans as a deduction from gross interest
- Build-up of allowance in early periods to absorb future losses
- No additional impairment if actual losses occur as initially expected

Year >	1	2	3	4	5
Income statement					
Gross interest	1,000	970	921	893	884
less expected loss	261	251	220	209	215
Net interest	739	719	701	685	669
Change in estimates	-	-	-	-	-
Balance sheet					
Amortized cost *	9,739	9,488	9,268	9,059	8,844
* footnote					
Loan	10,000	9,400	9,024	8,844	8,844
less: Allowance	(261)	88	244	215	(0)



Debt Security – IASB Model Interest Income & Impairment Change in Expected Cash Flows Year 2

Assumptions:

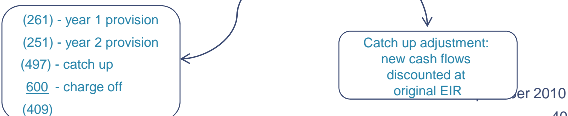
- Cash flows over the life of the pool are revised to reflect changes in expectations

Year >	1	2	3	4	5
Expected, original	1,000	970	921	893	9,728
Expected, new	1,000	970	912	866	9,153

Result:

- Adverse change in cash flow expectations results in a catch-up impairment loss
- This effect may be procyclical as the effect of changes in expectations are accelerated

Year >	1	2	3	4	5
Income statement					
Gross interest	1,000	970	912	866	840
less expected loss	261	251	248	220	210
Net interest	739	719	664	646	630
Change in estimates	-	(497)	-	-	-
Balance sheet					
Loan	10,000	9,400	8,836	8,483	8,313
Allowance	(261)	(409)	(93)	41	(0)
Amortized cost	9,739	8,991	8,743	8,523	8,313



What hasn't changed?

- Interest income recognition
  - Generally, the fees and costs will continue to be capitalized and recognized as a yield adjustment
  - Yield adjustment is retained for pools of prepayable instruments where prepayment estimates change
- Loss recognition
  - Previous guidance in determining when to evaluate impairment on a pool basis still intact – i.e., small-balance homogeneous loans, individual debt instruments that are not individually impaired and can be grouped based on similar risk characteristics
  - No changes to creditor's accounting for troubled debt restructuring
- Presentation
  - Interest income can be presented for FV-NI (ED is silent on how to compute)
  - Foreign currency transaction gains and losses on monetary items will be recognized with other fair value adjustments (i.e., in OCI for FV-OCI assets) – this applies to both debt securities and loans
- Scope
  - Lease receivables still evaluated under ASC 450 (i.e., FAS 5 probably loss)

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Comparison – Overall

	IASB	FASB
Objective	Provide information about the effective return on a financial asset by allocating interest revenue over the expected life of the instrument Effective return includes the initial estimate of expected credit losses "Yield" focus	Recognize credit impairment when an entity does not expect to collect all amounts due according to the contractual terms "Balance sheet" focus
Pros	Reflects the economic return of the portfolio	Potentially fewer operational issues as it retains elements of the current U.S. approach
Cons	• May "defer" losses for loans with large front-end losses (negative allowance) • Interest continues to be recognized at original expected EIR after loss rates change • Greater operational concerns (see earlier slide) • May still be procyclical	• Eliminates the probability threshold for recognition and likely would result in an immediate loss • Complexities retained for purchased impaired loans such as the need to constantly adjust EIR • May still be procyclical

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Hedge Accounting

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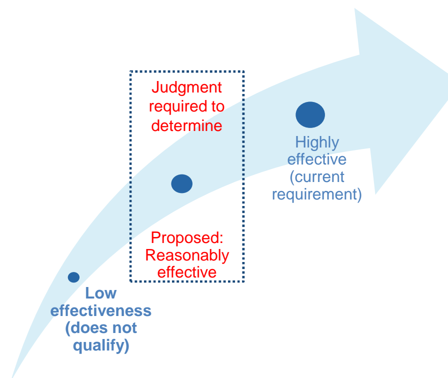
Key components of the new model
Hedge effectiveness criteria

- To qualify for hedge accounting under the proposed standard, a company will need to demonstrate and document at inception:
  - The risk management objective and the fact that an economic relationship exists between the derivative and the hedged item (or hedged forecasted transaction) AND
  - Changes in the fair value of the hedging instrument would be reasonably effective in offsetting changes in the hedged item's fair value or variability in cash flows
- Reasonably effective is purposefully not defined; judgment should be used: considered to be somewhere below highly effective, but it is not clear how much lower
  - Should consider all facts and circumstances as to why the entity entered into the hedging relationship, including considering the entity's objective for applying hedge accounting



Tax consideration: the proposed relaxation of hedge effectiveness criteria will align accounting more with tax, resulting in a likely decrease in book-tax differences.

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Comparison – Current versus proposed

	FASB, current	FASB, proposed
Effectiveness assessment and reassessment	• Prospective assessment at inception • Prospective and retrospective assessment each quarter • Assessments often quantitative	• Qualitative at inception (quantitative if necessary) • No quarterly requirement; reassess qualitatively (quantitative if necessary) only if changes in circumstances indicate hedge relationship may no longer be reasonably effective
Effectiveness threshold	Highly effective	Reasonably effective
Ineffectiveness for cash flow hedges	Record in the income statement, to the extent that there is over-hedging	Record all ineffectiveness in the income statement (over-hedging and under-hedging)
Shortcut and critical-terms match methods	Permitted when certain criteria met	Prohibited
De-designation of hedge at company's election	Permitted	Prohibited
Purchased options to hedge one-sided risk	Reclassify gain or loss accumulated in OCI into income when the underlying forecasted transaction impacts income	If ineffectiveness is calculated and recorded on the basis of total changes in the option's cash flows, amortize the cost of the option out of OCI into income on a rational basis

Questions & Feedback

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