

# IFRS 9 – Good things come to those who wait

## Mandatory adoption is approaching fast

IFRS 9 / AASB 9 finally becomes mandatory in Australia in 2018. Initial proposals for the new Standard were first made public back in 2009, but it took until July 2014 before a comprehensive Standard was issued. Whilst a good number of companies in Australia have already adopted some, or all, of the new accounting standard, for many, IFRS 9 represents as major change to come from the existing rules of IAS 39.

Normally, accounting changes of this nature lead to a significant amount of practical implications in terms of new reporting requirements and systems changes. Whilst IFRS 9 is not entirely exempt from some of these, there is far more good news than bad. Many of the changes to be adopted deal directly with some of the issues of IAS 39. I believe corporates will find the new rules will allow for much more flexible and effective risk management going forward.

The major benefits arise from both technical changes and a move towards more principle-driven accounting. Quantitative restrictions and artificial barriers have been removed allowing for much great freedom of action in terms of potential hedging instruments, but more importantly strategies. We examine these changes in more detail below as well as providing some examples of how these may influence future behaviour, highlighting the importance of an up to date treasury policy to ensure companies are able to take advantage of the benefits on offer.

## Technical changes are important for certain products

A key new concept introduced by IFRS 9 is that of “costs of hedging”. This relates to specific costs that companies entering into hedging transactions cannot avoid as they are a component of the hedging instrument itself. The most obvious relates to options, specifically the optionality component or “time value”. The other key example is currency basis. It is impossible to enter into an option hedge without acquiring optionality; similarly a currency swap cannot be transacted without the cost, or benefit, of currency basis being priced in. Neither, however, will normally impact the value or behaviour of the underlying exposure.

Under IAS 39, these factors would lead to volatility in earnings. Under IFRS 9, these items are treated as unavoidable costs and can be recognised in the P&L in a more appropriate way. For option time value this means either full deferral until the underlying transaction occurs, or systematic spreading over time, depending on the nature of the exposure. For currency basis, costs (or benefits) will be accrued to the P&L over the life of the hedge, with interim variations in value taken to OCI.

### **Example 1: Use of currency options to hedge foreign currency debt**

For many high cost currencies, such as IDR, INR, BRL etc., hedging foreign currency debt, normally USD, back into these currencies, has been viewed as too expensive. Options, particularly call spreads, have appeared economically attractive, as they provide some protection against depreciation whilst maintaining all the upside benefits of any appreciation, and at a lower cost than a full currency swap. However, the need to recognise time value in P&L, particularly for longer dated structures, has led to exposures remaining unhedged as the resulting earnings volatility could be greater, and much harder to explain to stakeholders, than simply doing nothing.

IFRS 9 will allow the cost of such optionality to be spread evenly over the lifetime of the borrowing, with other changes in time value taken to OCI. This grants companies the best of both worlds in terms of cheaper hedging costs, meaningful risk reduction and earnings outcomes that are easier to understand and explain. A number of companies in the Asia-Pacific region are already using this hedging strategy to good effect and it is likely that this trend will continue to strengthen once IFRS 9 becomes mandatory.

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There should no longer be a bias against certain hedging products as compared to others, an unfortunate reality under IAS 39. The need to expense time value on a mark to market basis has undoubtedly reduced the use of options as a hedging tool and is a prime example of the accounting “tail” wagging the risk management “dog”. Similarly, many companies have decided to convert foreign currency debt to fixed interest rates in their own currency to avoid potential hedge ineffectiveness, taking advantage of an anomaly for cash flow hedges under the current rules minimising ineffectiveness

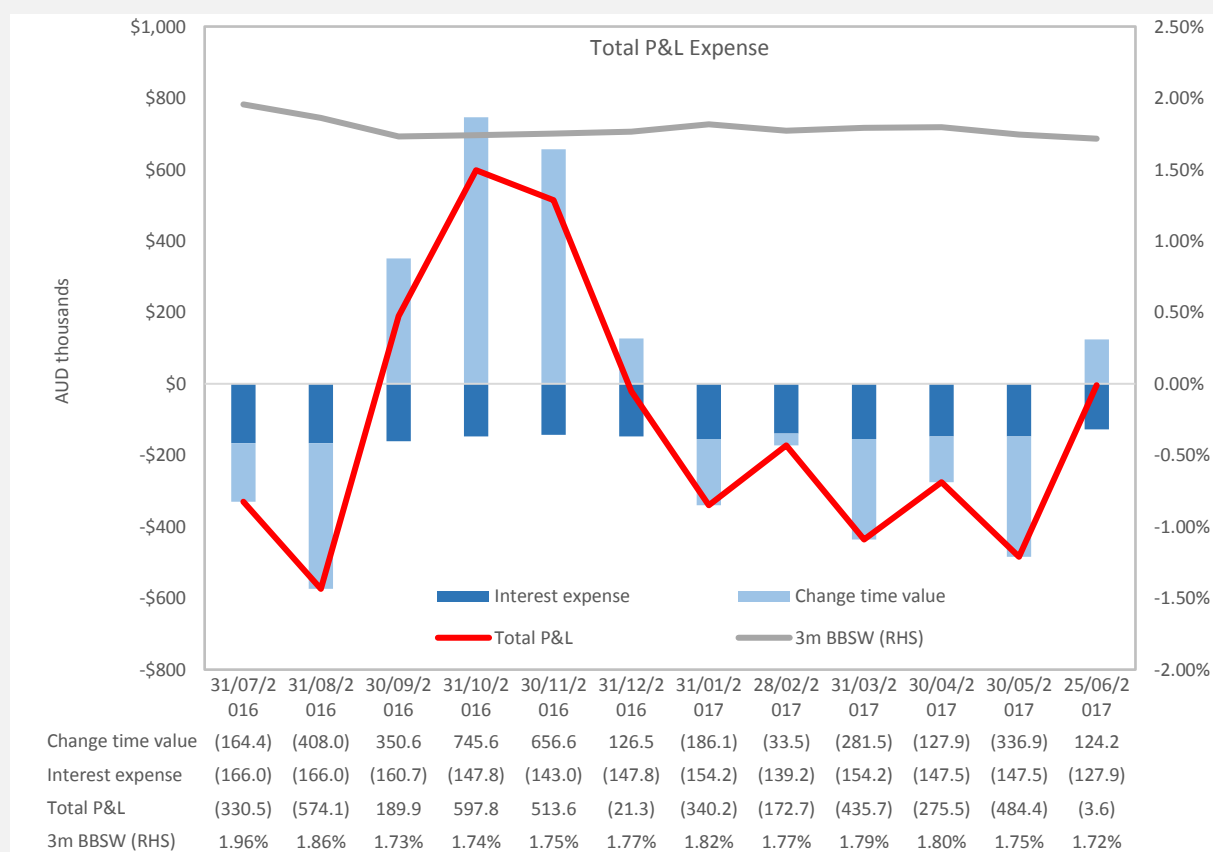
### Example 2: Use of interest rate options

A simple hedging strategy that is very rarely used currently is an interest rate collar. Whilst the product’s economics are simple - providing a maximum and minimum interest rate that a company will pay on any floating rate debt so hedged, the accounting for such an instrument is anything but.

In the example below we have looked at an Australian borrower paying interest based on 3m BBSW, and have assumed they borrowed AUD100m a year ago on June 30, 2016, when BBSW fixed at 1.96%. The borrower entered into a zero premium collar with a cap at 2.50% and a floor at 1.55% for 5 years.

The chart below indicates the relevant monthly interest costs over the following 12 months, based on historical fixings, as well as the change in time value of the collar. What is striking is that whilst BBSW has remained stable during the period, changes in interest rate volatility have led to very significant swings in the value of the collar, which in turn have led to significant volatility in earnings. This impact is unavoidable under IAS 39, and in some cases it is several multiples of that of the underlying interest charge itself, making the strategy undesirable for companies that want to avoid P&L volatility.

Under IFRS 9, all this volatility will be taken to OCI, leaving interest costs representing the true economic exposure of BBSW with a cap and floor, neither of which were reached during the period.



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Source: Reval SaaS

For commodity hedgers, the new ability to hedge components of non-financial risk will be invaluable. Previously, any difference between the price of the actual exposure and that of the commodity, in particular movements in this difference, led to ineffectiveness and made applying hedge accounting unnecessarily complicated. Going forward, it should be much easier to hedge component risk as this basis difference will not form part of the hedged item, which will instead be the smaller commodity component. The classic example here is the crude component of jet fuel, but there are many other applications across the commodities spectrum.

### **Dramatically increased freedom in terms of hedging strategies is the long term benefit**

Whilst technical changes are extremely helpful, the major benefits are likely to materialise from a mutually beneficial set of broader changes.

First of these is the underlying principle that the accounting result should reflect the economics of the underlying risk management decisions. Under IAS 39 this happens most of the time, but too frequently the accounting prevents risk being managed in the most optimal way, or actually reflects a different hedge designation to its underlying economic rationale, because doing so gets the accounting to “work” in terms of avoiding mark to market in earnings.

Second is the relaxation of the effectiveness test in that it will now be qualitative rather than purely quantitative. Whilst there are requirements for an economic relationship between hedge and exposure, conditions around the impact of credit risk and appropriate hedge ratios, these relaxations will allow more hedging instruments to achieve hedge effectiveness, and more importantly not fail for purely technical reasons relating to the mathematical 80-125% test.

Finally, and most significant of all, is the ability to hedge synthetic or aggregate exposures, that is economic exposures that are the result of a previously hedged position. This simple change, allowing a hedge on a previously hedged position, will dramatically improve the risk management decision process. There will no longer be a difference in the accounting outcome from hedging synthetic exposures when compared to hedging direct unhedged positions. Previously, this has led to some risks not being hedged or managed sub-optimally, as companies have been forced to compromise on their preferred hedging strategies and work within the confines of IAS 39.

#### ***Example 3: Managing different risks at different times in different ways***

A company needs to purchase a commodity priced in USD and hedges this with a forward contract locking in a fixed price. In terms of currency risk, this USD cash outflow is incorporated into their currency forecasts and managed in line with their FX risk policy, which includes the use of FX options.

Previously managing the commodity and FX exposures in different ways, and at different times, with different strategies and hedging instruments would have been extremely complex. Under IFRS 9 the separation of the two hedges, a direct result of being able to designate a synthetic fixed USD flow as a hedged item, becomes relatively straightforward

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### **Example 4: Different risks, multiple hedging strategies and costs of hedging**

In this example there is floating rate AUD borrowings as in example 2, except in this case, this floating rate exposure is the result of a 10 year fixed rate USD bond that has been fully swapped back to floating rate AUD with a cross currency interest rate swap. The borrower has taken advantage of the new rules regarding currency basis and is amortising the currency basis cost over the full 10 years. Changes in value of the swap resulting from movements in currency basis are deferred in OCI removing the first source of potential volatility.

Some time later, when reviewing its interest rate exposure, the company chose to increase its fixed rate debt by entering into the collar as described above. Under IAS 39, this strategy would have been difficult for two reasons. Firstly, the impact of time value as already discussed. Secondly due to the need to find an existing unhedged AUD floating rate exposure. Combining an historic cross currency swap and a new interest rate collar into a single hedge relationship, as required under IAS 39, would have been very difficult if not impossible.

The examples above provide just a few scenarios in which IFRS 9 will benefit corporate risk managers. The nature of the improvements made, and the way in which they positively interact with each other to create a virtuous circle of change, opens the door to a myriad of new products and hedging strategies. Whether it be the ability to use more dynamic hedging strategies that evolve over time, taking advantage of the new rules on portfolios to hedge a basket of currency exposures together, or utilising the new options guidance to manage the tail risks associated with foreign currency assets, the possibilities, if not exactly endless, are no longer so rigorously confined.

### **Prepare for the best: Time to review Treasury Policy**

Whilst risk management policy most often focusses on the downside and preparing for the worst, the introduction of IFRS 9 provides an opportunity for companies to do the opposite. In order for companies to get the most out of the new Standard, they need to ensure they are ready, not just in terms of practical processes and systems, but most importantly in terms of treasury policy.

The principle that accounting results should reflect a company's risk management strategy holds true provided that that strategy is in line with documented risk management policy. As a result, it is crucial that treasury policy is updated to make sure that it is consistent with current hedging activity in order to avoid any potential issues on transition.

IFRS 9 provides the perfect opportunity for companies to reassess existing policy and make sure it is fit for purpose going forward and they are in a position to take advantage of the benefits IFRS 9 presents. Every company's perspective will be unique, but what is universal is the opportunities being presented. Act now to make sure your organisation is in a position to take advantage.

### **About the Author**

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