

# Hedge Accounting Under US GAAP

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## EXECUTIVE SUMMARY

Under US Generally Accepted Accounting Principles (US GAAP), companies across all sectors rely on the hedge accounting principles enshrined in Accounting Standards Codification (ASC) 815 to manage risk. However, they are often limited to using risk management tools outside of hedge accounting, due to certain prohibitions and technical complexities.

This whitepaper explores the issues faced by financial and non-financial institutions in applying hedge accounting for interest rate risk, foreign exchange (FX) risk and other risks. It highlights both the prescriptive nature of ASC 815 and the inconsistent interpretations among auditors, which together create operational burdens and can limit hedging strategies. The paper proposes potential solutions to these challenges, including the expansion of hedge eligibility and the revision of hedge accounting criteria, to allow better use of existing risk management tools.

All companies must navigate complex risks including interest rate changes, currency fluctuations and market volatility. If companies cannot apply hedge accounting to mitigate risk, this may result in financial reporting and earnings volatility that users of financial statements cannot easily discern. Effective risk management is crucial for financial stability, but existing guidance in ASC 815 prohibits the application of hedge accounting to certain hedging strategies.

The paper advocates for a holistic review of the hedge accounting framework to address these limitations, improve alignment with risk management activities and enhance the usefulness of financial statements.

## RECENT HISTORY OF HEDGE ACCOUNTING OUTREACH

During the 2014-2017 hedge accounting project that culminated in Accounting Standard Update (ASU) 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, a selection of issues were addressed, with a longer list of issues considered for inclusion in a Hedge Accounting Phase II project. After the successful issuance of the 2017-12 ASU, the Financial Accounting Standards Board (FASB) identified certain narrow hedge accounting issues to be immediately addressed, along with reference rate reform relief, rather than address the Phase II project in the short term.

However, the FASB delayed the Phase II project because of issues relating to reference rate reform. In 2021, it requested feedback from market participants on its standard-setting agenda. Market participants, including ISDA's North America Accounting Committee, encouraged the board to prioritize Phase II due to a number of important issues that had been identified during the 2014-2017 hedge accounting project.

Since the 2021 consultation, the FASB has taken on targeted narrow-scope projects to improve ASC 815. While the market has welcomed these improvements, ISDA urges the board to prioritize the start of Phase II. This project will continue the constructive work that began in ASU 2017-12 to better align risk management activities with financial reporting, providing new opportunities to apply hedge accounting to fundamental risk management practices and give users of financial statements a better understanding of the interaction between risk management and financial statements.

In this paper, ISDA sets out the items that could be resolved in a Phase II project and the associated benefits.

## INTEREST RATE RISK

### Exposure to Interest Rate Risk

Interest rate risk refers to an entity's exposure to movements in interest rates, which is a fundamental risk arising from financing activities and impacts both financial and non-financial entities. Non-financial entities issue long-term debt or invest in financial instruments and therefore need to manage their interest rate risk. Failing to hedge interest rate exposure may lead to unplanned or undesired gains or losses on those financial instruments.

Entities are exposed to a wide range of fixed- and floating-rate instruments that need to be risk managed. Fixed-rate instruments with a fair value exposure to changes in interest rates include investments in securities, funding liabilities (eg, deposits or certificates of deposit), insurance liabilities (eg, structured settlements or annuities), short-term debt (eg, federal home loan bank advances or commercial paper) and long-term debt. Variable rate instruments with cashflow variability exposures include loans, investments in securities and short- or long-term debt.

Interest rate risk has various components, but duration is a key area of focus for risk managers. Duration is a measure of a financial instrument's price sensitivity to interest rate changes. It is generally expressed as the price change in a bond given a 1% change in interest rates over the remaining life of the instrument, reflecting its sensitivity to interest rate changes throughout its term. The higher the duration, the greater the sensitivity to interest rate changes, so a bond of higher duration will drop more in price for a given rise in yields. A bond with a longer time to maturity and a lower coupon rate will have higher duration risk relative to a bond with shorter time to maturity or a higher interest rate.

A floating-rate debt instrument has a much lower duration as it periodically reprices as rates rise or fall – this is usually near zero, depending on the frequency of repricing. Duration of equity (DOE) measures the change in the value of the core banking book (eg, loans, deposits, available-for-sale and held-to-maturity securities, debt and qualifying ASC 815 hedges) for a 1% change in rates as a percentage of tangible common equity.

Most banks have negatively convex DOE because of their balance sheet composition. For example, the pre-payment option in mortgage loans creates an unfavorable change in duration as interest rates change, regardless of an upward or downward direction of rates. Banks tend to achieve longer duration as interest rates rise and shorter duration when they fall. Without a robust inventory of hedging strategies available to companies, negatively convex positions result in increasing losses in value as interest rates continue to rise or fall.

Pre-payment risk, or the risk of a premature return of principal on a fixed-rate loan or security, will directly impact the duration risk of the creditor/investor. As rates rise, a pre-payable available-for-sale (AFS) or held-to-maturity (HTM) security's duration lengthens or extends as borrowers are less likely to pre-pay low-rate borrowings. The extension results in a larger long position in a rising rate environment in which bond prices fall as rates rise. Alternatively, as rates fall and deposits reprice more frequently, their duration shortens or contracts as depositors are more likely to seek higher yields by transferring their cash on deposit into money market funds or time deposits. From a duration perspective, deposits more closely resemble floating-rate liabilities than fixed-rate liabilities in a falling rate environment.

In addition to the impact on earnings, interest rate risk also affects the value of an entity's assets and liabilities carried at fair value and therefore affects equity/capital. From an economic perspective, even if the instruments are not accounted for at fair value, there could still be an impact on earnings

and capital if the instrument is sold prior to maturity (recovery). Effective risk management strategies are required to address this risk, both from the perspective of its effect on earnings and on the economic value of its assets and liabilities, whether measured at fair value or not (ie, its impact on net assets/equity).

During the COVID-19 pandemic, banks received an influx of deposits while interest rates approached zero, which shortened their DOE. Banks bought fixed-rate securities to offset the decrease in duration as a hedge for interest rate risk. The HTM classification was frequently used, for several reasons. First, the low interest rate environment increased the risk of other comprehensive income (OCI) losses if rates increased, negatively affecting capital. The capital treatment associated with OCI volatility from holding AFS securities is more punitive than similar potential losses from other investments.

As interest rates were held at historic lows during the pandemic, the risk of OCI losses from rising interest rates became a significant concern. As a result, banks favored HTM classification to avoid the capital impact of potential OCI losses, a consideration that remains relevant even after the pandemic. HTM classification is also preferred due to constraints on the amount of receive-fix swaps that can be designated as cashflow hedges for floating-rate loan assets due to the risk of failed forecasts. The origination of floating-rate loans is a core banking activity and no bank can afford to lose the privilege of applying cashflow hedge accounting. Additionally, while banks experienced a significant influx of deposits, they faced challenges in expanding their loan originations to match the deposit expansion, also leading to increased HTM investments.

As the Federal Reserve began raising interest rates, deposits repriced more frequently (ie, contracted) and pre-payments on fixed-rate securities and loan assets slowed (ie, extended), resulting in a lengthening of DOE. The inability to hedge the interest rate risk in HTM securities for the period that the macro environment materially changed contributed to this duration extension. The ability to apply a qualifying hedge accounting relationship to HTM securities would have facilitated better interest rate risk management without impacting the original objective of investors to hold securities to maturity.

While interest rate risk was not the only factor contributing to the bank crises in early 2023, the ability to apply hedge accounting to deposits and HTM securities, which are among the most significant elements of bank balance sheets, may have mitigated some of that risk.

## Why and How Interest Rate Risk is Managed

All institutions that hold interest-bearing assets or liabilities or other financial instruments are exposed to changes in interest rates. As interest rates rise, fixed-rate financial assets decrease in value, and interest income from floating-rate financial assets rises. As interest rates decline, the fair value of fixed-rate financial assets increases and the interest income from floating-rate assets decreases. The opposite is true for fixed-rate and floating-rate liabilities.

From a risk management perspective, the sensitivity of the value of financial assets and liabilities to changes in interest rates is commonly expressed as a dollar change in value per basis point. This sensitivity to change may vary at different levels of interest rate. Firms can aggregate these sensitivities across the entire balance sheet to measure outcomes under various interest rate scenarios. Risk managers responsible for asset and liability management (ALM) are responsible for ensuring that this overall net balance sheet sensitivity to interest rate changes is within acceptable limits.

In complex financial institutions, the ALM function is focused on management of the balance sheet, rather than on individual transactions, given their volume. ALM manages risk by using 'natural hedges' in which the interest rate risk of certain assets and liabilities offset each other, as well as using investments in securities and cash deployment strategies, and using derivatives as hedging instruments.

Risk management strategies are created based on the specific operations of an entity, including the actual and projected balance of fixed- and floating-rate financial assets and liabilities; hedging in a qualifying hedge accounting relationship is a common part of a company's risk management strategy. The most common derivatives used to manage interest rate risk include swaps, futures, options, caps and floors.

## Challenges with Achieving Hedge Accounting

Hedge accounting has historically been operationally challenging to achieve and implement in certain circumstances. While the FASB has made targeted improvements and simplifications to the hedge accounting model in ASU 2017-12, there are still several limitations within the current framework that impede the ability of entities to apply hedge accounting to certain interest rate risk exposures.

This paper presents a subset of issues with the current hedge accounting model to illustrate the need for standard setting in a Phase II hedge accounting project and includes workable solutions. Certain issues could be addressed as part of a narrow-scope improvement project, but ISDA urges the FASB to avoid any unnecessary delays in initiating a full-scope project.

## Fair Value Hedge Accounting for Interest Rate Risk

### Issue 1: Ability to Hedge Interest Rate Risk on HTM Securities

Securities classified as HTM cannot be hedged for interest rate risk, on the basis that an entity should be indifferent on how interest rate risk may affect the value of HTM securities because it is committed to holding the securities until maturity, thus receiving the full amount of its anticipated return, regardless of interest rates.

However, for ALM reasons, managing the risk of the entire balance sheet, including economically hedging HTM securities, has always been required. Despite a bank holding HTM securities to maturity, the long duration exposure of those securities may need to be reduced due to other changes within the balance sheet. For example, as deposits contract (in duration terms, get shorter), the net duration of the balance sheet will become too long, resulting in the need to reduce fixed-rate assets, or swap them to floating rates in order to return to the previous net duration position.

Since HTM securities can neither be sold nor hedged for interest rate risk, the financial institution is hamstrung in its risk management options for a significant asset portfolio. Other available assets or liabilities can sometimes be designated as hedged in place of hedges of the HTM securities, but often the amounts of available hedged items are constrained by the presence of existing hedges, the strike risk in cashflow hedges, or the inability to qualify for hedge accounting.

The prohibition of interest rate risk hedge accounting for HTM securities is inconsistent with how entities approach their interest rate risk management, as this is done on a balance sheet-wide basis rather than by individual securities. In the absence of a macro hedging strategy, allowing entities to hedge the interest rate risk of HTM securities as part of ALM would significantly improve entities' abilities to align the hedge accounting guidance with risk management activities. Such alignment was a key objective of the ASU 2017-12 project and a key reason for its success.

In Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133), the FASB explained in its basis for conclusions that the ability to hedge a HTM position would contradict the logic of its classification. This is because when an entity makes this classification, it is inherently asserting that it intends to hold the security until maturity and recover the principal, disregarding any effects of changes in interest rates.

Further, in the basis for conclusions of FAS 133, paragraph 429 states: "the Board does not consider it inconsistent to prohibit hedge accounting for a hedge of market interest rate risk in a held-to-maturity debt security while permitting it for hedges of other items that an entity may be holding to maturity. Only held-to-maturity debt securities receive special accounting (that is, being measured at amortized cost when they otherwise would be required to be measured at fair value) as a result of an asserted intent to hold them to maturity."

However, held-for-investment (HFI) loans that an entity intends to hold for the foreseeable future are held at amortized cost and are allowed to be transferred to the held-for-sale (HFS) category when the entity determines it has developed an intention to sell. An entity's management makes a positive assertion at origination or purchase regarding its ability and intention to hold or sell loan receivables. However, unlike HTM securities, hedge accounting for interest rate risk is permitted not only for HFS loans measured at the lower of cost or market, but also for HFI loans, which, like HTM securities, are measured at amortized cost.

While the classification criteria for HFI loans is a less restrictive hurdle in comparison to the criteria for HTM securities, and the reclassification between HFI and HFS is simpler, a vast majority of HFI loans are held to their legal and final terms by institutions. Despite there being a higher bar for reclassification between securities categories and their measurement requirements, securities' coupon interest still impacts earnings in a similar fashion to HFI loans. Hedge accounting has been deemed appropriate for loans that are in many cases held to maturity and impact earnings in similar ways to HTM securities.



If the application of hedge accounting to HFI loans is not deemed to impact the entity's intention to hold the loan for the foreseeable future, ISDA believes there are circumstances in which this can be true for HTM securities as well – for example, when such hedges are conducted as part of an entity's ALM activities. An entity's decision to classify a security as HTM means that, during the term of the security, the entity's intentions with respect to that security will not be affected by interest rate changes, but hedging the interest rate risk of the security can be viewed separately from the ability and intention to hold the security to maturity, similar to the approach for HFI loans. Expanding the ability to hedge HTM securities appears to align with the existing ability to hedge HFI loans and should be permitted in the short term.

### Issue 2: Ability to Apply the Shortcut Method on Forward-starting Fair Value Hedges

The shortcut method is the primary method of interest rate risk hedge accounting for smaller or less financially complex entities. The shortcut method for interest rate swaps requires all of the formal hedge documentation at inception, but it requires no ongoing assessment of hedge effectiveness if all of the criteria for its use are met at the inception of the hedge. This relieves much of the complexity and operational burden of performing quantitative assessments both at inception and on an ongoing basis.

ASC 815-20-25-102 through 25-111 and ASC 815-20-55-71 provide specific guidelines on when an interest rate swap may be assumed to be a perfectly effective hedging instrument. The criteria include: limiting the use of the shortcut method to hedges involving interest rate swaps, requiring that the notional amounts of the derivative and hedged item must match, the fair value of the swap is zero at inception, the formula for computing net settlements under the swap is the same for each net settlement, the hedged item is not pre-payable, and other terms in each instrument must be typical for those instruments and do not invalidate the assumptions of perfect effectiveness.

For a fair value hedge, the swap must also meet all of the following additional conditions, as described under ASC 815-25-105:

- The expiry date of the swap must match the maturity date, or assumed maturity, of the interest-bearing asset or liability;
- There can be no floor or ceiling on the variable interest rate of the swap;
- The interval between repricing of the variable leg of the swap must be frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less);
- The index on which the variable leg of the interest rate swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.

There is an interpretation among audit firms based on discussions with the FASB staff that forward-starting interest rate swaps are not considered to have a consistent formula for computing net settlements, because the settlements occur only after the effective date and not between the trade date and effective date. However, the guidance does not suggest this was the FASB's intention.

There are instances in which companies may know they will enter into interest-bearing assets or liabilities in the future. Based on their expectation of whether rates will go up or down, they may want to enter into a forward-starting swap. While this risk can be hedged under the long-haul method, disallowing the use of the shortcut method for forward-starting swaps persuades many of these less financially sophisticated companies not to enter into a derivative at the inception of the risk.

As a result, the stringent hedge accounting requirements can directly affect an entity's risk management decisions. In addition, there is an inconsistent application where a spot-starting partial-term hedge would qualify under the shortcut method, whereas a forward-starting partial-term hedge would not qualify. The FASB could resolve this interpretation by providing clarification that the shortcut method can be applied while using a forward-starting swap.

## Proposed Updates to the Fair Value Hedge Accounting Model

There are significant issues with the existing fair value hedge accounting model that impact the ALM decision-making of complex financial institutions. Their inability to specifically hedge deposits or HTM securities directly affects when and how they may decide to use derivatives to manage exposures. Additionally, while not as pervasive, entities that principally use the shortcut method may decide not to hedge certain risks that do not qualify for the shortcut method.

The inability to hedge interest rate risk on HTM securities has created a broader misalignment between entities' practical risk management activities and the accounting treatment when hedging the interest rate risk of the balance sheet, including that contributed by HTM securities. Institutions typically manage risk on a comprehensive, balance sheet-wide basis, which conflicts with the restrictions placed on hedging individual HTM securities. This restriction not only limits the effectiveness of financial institutions in hedging interest rate risks but also leaves them with portfolios of fixed-rate instruments susceptible to interest rate volatility. It also contradicts the treatment of HFI loans, which can be hedged despite often having similar investment periods and amortized cost accounting treatments.

While ISDA would support a targeted project to address Issues 1 and 2, thereby resolving significant and pervasive issues, these are technical and complex matters and a holistic re-examination of the hedge accounting framework may be a better way to address these issues. This project should more closely align the fair value hedge accounting model with risk management practices. This would include the ability to apply hedge accounting to the full spectrum of interest-bearing assets and liabilities on the balance sheet, as well as to forecasted transactions.

Permitting hedge accounting for HTM securities would enable institutions to apply consistent risk management practices across their portfolios without the current accounting restrictions. It would also support a more holistic approach to managing interest rate risk, enhancing the overall responsiveness to market conditions. In addition, having the ability to apply hedge accounting to HTM securities would also converge US Generally Accepted Accounting Principles (US GAAP) with international accounting standards under International Financial Reporting Standards (IFRS) 9, Financial Instruments.

## Cashflow Hedge Accounting for Interest Rate Risk

### Issue 3: Hedging Forecasted Bond Purchases

A pre-requisite for applying cashflow hedge accounting is a requirement that the forecasted hedge transaction can be specifically identified when it occurs. This includes strategies in which hedges of forecasted bond purchases may be defined as either the purchase price of a seasoned bond or the variability of fixed interest payments related to newly issued bonds in the same hedge relationship. However, the risk being hedged must be defined upfront as either the variability in the purchase price, in the case of a seasoned bond, or the variability in coupon payments, in the case of a new issuance.

From a risk management perspective, companies do not usually draw a distinction between whether a future purchase will be a seasoned bond or a new issuance. At the time of designating a derivative in a hedge relationship, this requirement substantially limits the future purchases they are able to hedge, as there is uncertainty over which category the forecasted purchase will fall under, and a concern as to whether the cashflows are considered probable under the hedge accounting model.

#### Issue 4: Hedging Forecasted Issuances

Similar to the previous issue, when designating a derivative in a hedge of a forecasted transaction, the hedged cashflows must be specifically identifiable. From a risk management perspective, entities are hedging the interest rate risk of a forecasted issuance, but not necessarily whether that forecasted cashflow will be cashflows from the proceeds on the issuance (if, for example, a bond is re-issued in the secondary market with the same coupon) or a series of future coupon payments.

For Issues 3 and 4, the ability to include in an entity's risk management the forecasted transactions that include an element of uncertainty of terms could be addressed by re-assessing how the forecasted transaction is identified. Whether entities are hedging the forecasted proceeds, purchase price or forecasted coupons, the risk management objective is the same from the perspective of the entity. As such, the FASB could allow companies to define forecasted bond purchases more broadly, without the need to specify whether the bonds will be seasoned or new issuances. This would acknowledge the practical realities of risk management and reduce the constraints on hedge designations. For example, entities could hedge the overall exposure to interest rate risk on forecasted bond purchases, regardless of the bond type.

#### Issue 5: Determining a Missed Forecasted Transaction

According to ASC 815-20-25-15, a forecasted transaction in a cashflow hedge is eligible to be hedged so long as it remains probable. In accordance with ASC 815-30-40-4 through 40-5, in the event a forecasted transaction is no longer probable within 60 days of the original specified time period, the hedging relationship must be de-designated and amounts previously deferred in accumulated other comprehensive income (AOCI) are reclassified into earnings.

A pattern of determining that the hedge forecasted transactions are no longer probable would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using cashflow hedge accounting in the future for similar forecasted transactions. Given the importance of hedge accounting to ALM activities, the possibility of a failed forecast is of the highest concern to risk managers at financial institutions.

There are severe accounting consequences if a forecasted hedged transaction does not occur within 60 days of the forecasted time period. If this occurs multiple times, an entity may lose the ability to apply cashflow hedge accounting in the future for similar transactions. The potential consequences of losing the eligibility to hedge forecasted transactions can greatly restrict the amount and extent to which an entity may be willing to designate in cashflow hedge relationships.

This issue could be alleviated, without removing the toll gate that the forecasted transactions must be probable, by revising the current guidance that forecasted hedged transactions must occur within 60 days of the original forecast by providing relief for continued hedge accounting as long as the forecasted transactions remain probable based on the circumstances and the hedging relationship continues to be highly effective based on the revised forecast. This would more closely align US GAAP with IFRS.

### Issue 6: Deal Contingent Swaps to Hedge Deal Contingent Debt

A common hedging strategy for companies is to enter into a swap that only becomes effective if the associated transaction (eg, an entity borrowing money) is consummated. The company may enter into a swap early due to its view of the current interest rate environment and, if the deal is not executed, the swap will never become effective. However, under the existing accounting guidance, if the deal is not executed, this scenario would constitute a missed forecast and could inhibit the entity's ability to apply cashflow hedging in the future.

Identification of the forecasted hedged transaction, and the requirement that it remains probable, is included in the accounting guidance to prevent potential abuse of the special accounting treatment allowed for derivatives under cashflow hedge accounting (eg, changes in fair value are deferred in OCI rather than profit and loss). In this circumstance, the derivative would not have any significant value until the deal is executed and in this example is cancelled without penalty if the transaction is cancelled. However, this failure to execute would still be considered a missed forecast that could call into question an entity's ability to forecast in the future. While the probability of cashflows concept is important to retain in the guidance to avoid potential abuses, there are possible changes that could sufficiently address the anti-abuse concerns while still allowing for additional risk management activities to be conducted.

If the FASB would not allow for the extension of the allowable period for forecasted transactions beyond the current 60-day window, an alternative would be to incorporate a buffer period if potential delays are identified within the documentation at the inception of the hedge. For instance, the entity would provide detailed documentation of the expected timing and conditions of the hedge and further document any potential contingencies that could impact the timing of the forecasted transaction.

If the entity can provide adequate documentation and justification around these contingencies, the FASB should allow for a buffer period beyond the 60-day window. This additional requirement could also be applied at hedge inception when there are known contingencies around the timing of the forecasted transaction. This approach would allow a more lenient interpretation of a missed forecast without permitting the entities to misapply hedge accounting under ASC 815. Issue 6 could be further addressed by allowing deal contingent transactions to be hedged with deal contingent derivatives. Such derivatives would not result in gains or losses at maturity and therefore would not create the potential for abuse that the probability rules are designed to prevent.

### **Proposed Updates to the Cashflow Hedge Accounting Model**

The key issues with the cashflow hedge accounting model can be grouped into two areas:

- 1) Identifying the forecasted transaction (Issues 3 and 4);
- 2) Determining when a missed forecast has occurred (issues 5 and 6).

A broad-scope project to amend and improve the cashflow hedge accounting model could give entities greater flexibility to manage the interest rate risks associated with their forecasted transactions. In particular, this flexibility would help to align hedge accounting practices with actual risk management activities, thus making hedging strategies more effective and responsive to market conditions. Issues 3 and 4 highlight the stringent criteria in ASC 815 to identify the forecasted transaction, which significantly reduces the total volume of transactions a company is able to hedge. Issues 5 and 6 highlight the punitive consequences of a missed forecast, even in situations where a swap may be known to be contingent.

## FOREIGN EXCHANGE RISK

### Exposure to FX Risk

There are two main types of FX risk to which entities are exposed: transaction risk and translation risk.

Transaction risk refers to the gains or losses that a foreign currency-denominated transaction may incur due to currency fluctuations. Buyers and sellers in different countries rarely use the same currency, which means as part of any transaction the currency used for payment must be agreed and will likely not be the functional currency of at least one of the parties. Between the time the terms of a transaction and the related foreign currency payment terms are agreed and the execution/settlement of the transaction, the entity is exposed to changes in the exchange rate of the foreign currency relative to the entity's functional currency.

The second type of FX risk relates to translation, which can affect market participants that operate in multiple countries. When a parent company consolidates subsidiaries in foreign countries, the parent faces potential volatility when it translates the subsidiaries' financial statements into its own reporting currency.

### Why and How FX Risk is Managed

FX risk is managed to reduce an entity's exposure to fluctuations in the functional currency equivalent prices or cashflows of transactions executed in other currencies, or for parent entities that consolidate a foreign subsidiary with a different functional currency, which creates translation risk. Derivatives such as cross-currency swaps, FX forward contracts, futures and options are commonly used to mitigate FX risk.

The most common approach to managing FX risk is by entering into an FX forward contract, which enables the purchaser to buy or sell a set amount of foreign currency at a pre-agreed exchange rate that will be delivered when the hedged transaction occurs.

### Challenges with Achieving Hedge Accounting

The following issues relate to common FX strategies in which the application of ASC 815 creates unnecessary barriers to achieving hedge accounting. These issues can likely be addressed through further standard setting from the FASB.

### Cashflow Hedge Accounting for FX Risk

#### Issue 7: Foreign Currency Hedging of Business Combinations

The guidance under ASC 815-20-25-15 (g) specifically prohibits entities from designating a forecasted business combination as the hedged item in a cashflow hedge of FX risk. The basis for conclusions to FAS 133, paragraphs 455 and 472, indicate that the FASB implemented this prohibition because cashflow hedge accounting for those items could present significant practical and conceptual problems, such as determining when to transfer to earnings amounts accumulated in OCI.

For the purpose of hedging the FX risk associated with a commitment to execute a business combination, there would not be significant practical or conceptual challenges for implementation that are not present for other risks. For example, the change in fair value of the hedging instrument would be deferred in OCI and reclassified into earnings following the IFRS guidance for when the acquired entity impacts earnings, therefore aligning US GAAP more closely with IFRS.

Under IFRS 9, entities are not permitted to hedge a firm commitment to acquire a business with one exception. It is permitted to hedge the FX risk associated with business combinations because this is a risk that can be specifically identified and measured, while other risks are general business risks. During the hedging period, the effective portion of the gain or loss on a hedging instrument in a cashflow hedge is recognized in OCI. Upon initial recognition of the acquisition, gains or losses recognized in OCI are included in the amount paid for the business combination that is designated as the hedged item (IFRS 9.6.5.11(d)(i)). This treatment ensures the hedging relationship is maintained and the hedging results are appropriately matched with the underlying transaction.

To align with the IFRS 9 model, ISDA proposes the following adjustments to the current guidance under ASC 815-20-25-15(g) to allow entities to designate a forecasted business combination as the hedged item in a cashflow hedge of FX risk, similar to IFRS 9. This would involve recognizing the gain or loss on the hedging instrument in OCI during the hedging period. Upon the initial recognition of the business combination, any gains or losses recognized in OCI should be included in the amount paid for the business combination. This treatment would provide a more accurate reflection of the economic impact of the hedge and ensure consistency with IFRS 9.

In addition, when hedging the FX risk associated with business combinations, deal contingent hedging is common practice. The same points set out under Issue 6 when using deal contingent swaps to hedge deal contingent debt for interest rate risk would also apply to hedging FX risk.

#### Issue 8: Hedging Net Income for FX Risk

Under ASC 815, there is an inability to hedge the translation risk that arises from translating a foreign subsidiary's net income into the group's functional currency. ASC 815 prohibits hedging the FX risk of a subsidiary's net income, because net income is considered to contain both forecasted inflows and outflows.

ASC 815-20-25-39 stipulates: "If the hedged transaction is a group of individual forecasted foreign currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group." Instead, entities must separately hedge the FX risk associated with foreign-denominated revenues and foreign-denominated expenses.

This approach is limited and incomplete as hedge accounting cannot be achieved for all revenues or expenses, leaving some FX risk unhedged. Entities decide whether to execute FX derivatives based on their net exposures as the offsetting foreign-denominated revenues and expenses are a natural hedge.

This limitation also exists for net investment hedges, which disallows the hedging of anticipated operating income, thereby preventing entities from effectively managing their overall FX exposure and necessitating separate hedging strategies for individual components of the net investment. While a change to this view would represent a fundamental change in the hedge accounting framework, ISDA believes an exception to address this pervasive market issue would be appropriate.

Without a specific exception, a more holistic review of the hedge accounting framework could address this issue. Creating the ability to hedge translation risk would be a major change that would provide a significant improvement and another way for entities to hedge FX risk.

### Issue 9: Hedging Foreign Currency Risk in a Forecasted Purchase or Issuance of an FX-denominated Financial Asset or Liability

Based on historical views from the Derivatives Implementation Group (DIG), which were tentatively published in DIG Issue H17 (Foreign Currency Hedges: Hedging Functional-Currency-Equivalent Proceeds to Be Received from a Forecasted Foreign-Currency-Denominated Debt Issuance) but never finalized, entities are not permitted to hedge a forecasted purchase or issuance of financial assets or liabilities for FX risk. While such a forecasted transaction represents a true economic and cashflow risk, as the amount of foreign currency required to execute the forecasted transaction may change before execution, this risk is not considered to directly affect an entity's earnings.

From an economic perspective, changes in the exchange rate will directly impact the functional currency equivalent purchase or issuance price of a foreign currency-denominated item. The cost basis of the purchased asset or issued liability would be affected, which can also affect future interest receipts and payments. As a result, entities want to hedge this risk to obtain certainty over their future cashflows in their functional currency. As such, the FX risk before purchase or issuance will have a direct impact on the amounts recognized in earnings as well as the amount of the forecasted cashflows.

An entity is left with a decision to either economically hedge this risk without hedge accounting and be exposed to volatility in earnings by holding a trading derivative or leave the exposure unhedged. When entities economically hedge the risk without hedge accounting, they hold trading derivatives whose fair value changes are recorded in earnings. This leads to earnings volatility as gains or losses on the derivatives reflect immediate changes in exchange rates.

Additionally, an analogy can be drawn with hedging a debt issuance on the trade date, even though it is not recognized until settlement date. For example, an entity can designate an interest swap in a fair value hedge relationship (if the debt is fixed rate) or cashflow hedge relationship (if the debt is floating) to hedge the interest rate risk on the debt that will not be recognized on the balance sheet until settlement (eg, five days later).

As a result, the entity is permitted to designate the interest rate risk on a financial instrument that does not currently impact earnings in a hedge relationship. Similarly, if an entity is able to forecast its future purchases or issuance of foreign currency-denominated financial assets or liabilities, it should be able to designate a derivative to hedge the foreign currency risk in a hedge relationship under ASC 815.

Similar to the issues already addressed, there is an inability to identify certain activity as the hedged item because the net income of a foreign subsidiary or the foreign currency risk in a forecasted transaction is ineligible under ASC 815. ASU 2017-12 was intended to give entities an improved ability to apply hedge accounting, consistent with their risk management strategies. This is another example of where the codification could be amended to further this objective. A project to re-assess how the hedged item and hedged risk are identified and defined would expand the ability of entities to apply hedge accounting to business activities that introduce true economic risk.

### Issue 10: Hedging a Net Investment with a Float-to-float Swap

According to ASC 815-20-25-67, hedging instruments that are eligible for designation in a net investment hedge include a receive-variable-rate, pay-variable-rate cross-currency interest rate swap, provided the interest rates are based on the same currencies contained in the swap and both legs of the swap have the same repricing intervals and dates.



This is because a cross-currency interest rate swap with either two floating legs or two fixed legs has a fair value that is primarily driven by changes in FX rates rather than changes in interest rates. Therefore, FX risk rather than interest rate risk is the dominant risk exposure in such a swap.

Following reference rate reform, how reset dates are applied began to vary significantly across different rates and jurisdictions. As a result, it is difficult to achieve hedge accounting using a float-to-float swap in a net investment hedge. However, entities should still be permitted to use a float-to-float swap in a net investment hedge even when repricing dates do not align, as long as the interest rate tenor is the same across currencies.

### Proposed Updates to the Foreign Currency Hedge Accounting Model

A common theme across each of the issues addressed in this section is the identification of the hedged item. In each case, specific exceptions or modifications could be made to the existing hedge accounting framework to more closely align the guidance with management practices.

For example:

- Specifically allowing FX risk to be designated in a cashflow hedge of a business combination while other risks associated with business combinations are not permissible;
- Creating an exception to what can be designated as a hedged item or clarifying certain criteria would resolve other issues;
- Allowing net income to be designated as a hedged item when hedging FX risk;
- Allowing the FX risk in a forecasted purchase or sale of a foreign currency-denominated asset or liability;
- Relaxing some of the criteria for float-to-float cross-currency swaps in a net investment hedge.

Similar to the cashflow hedging model, stringent hedge accounting criteria that prohibit identifying certain transactions as eligible to be hedged restrict an entity's ability to effectively manage risk. Due to the complexity of these issues, a broad improvement project for the FX hedge accounting model should be undertaken to holistically re-assess how companies may determine the hedged item and associated foreign currency exposure they are seeking to hedge.



## OTHER CHALLENGES WITH THE HEDGE ACCOUNTING FRAMEWORK

Aside from issues related to hedging interest rate risk and FX risk, other challenges under the existing ASC 815 hedge accounting framework include an inability to hedge inflation risk, commodity risk and certain other implementation challenges.

### Inflation Risk

Inflation risk is not currently eligible to be hedged under ASC 815 and it is not viewed as a contractually specified interest rate that can be hedged in a cashflow hedge accounting relationship. From an economic perspective, the holder of a bond faces reinvestment risk due to inflation at the bond's maturity. For example, when a bond matures, the holder receives \$100 but the economic value of that \$100 is less than it was at the time of purchasing the bond if inflation was rising. If the bond was hedged for inflation risk, the value of the bond plus the derivative at maturity would be \$110 – \$100 for the bond principal and \$10 for the increase in the fair value of the derivative – allowing the holder to maintain the economic value of the bond.

### Commodity Risk

Commodity contracts can be classified into three categories:

- 1) Fixed Price: where the underlying for a commodity contract is to transact a fixed quantity of the commodity at a fixed price;
- 2) Variable Price: where the underlying for a commodity contract to transact a fixed quantity of a commodity at the prevailing market price;
- 3) Mixed: where a contract requires a purchase at the prevailing market price, plus or minus a fixed basis differential. This contract has two underlyings. One is the market price of the commodity and the other is the fixed spread basis differential.

In case of a mixed attribute contract, the entire contract meets the definition of a derivative instrument under ASC 815 because the basis differential is market variable and determines the final transaction price, and this variable has been fixed in the contract. As described in ASC 815-20-55-47: "Because its underlying relates solely to changes in the basis differential, the mixed attribute contract would essentially be hedging only a portion of the variability in cashflows. The entity is not permitted to designate a cashflow hedging relationship as hedging only the change in cashflows attributable to changes in the basis differential."

A limitation with mixed attribute contracts under ASC 815 is that the entire contract meets the definition of a derivatives instrument because it contains two underlying variables: the market price of the commodity and the fixed spread basis differential. This differential is a market variable determining the final transaction price and is fixed in the contract. This limitation means entities cannot designate a cashflow hedge for only the basis differential portion of the contract. The fixed basis differential in these types of contracts can fluctuate based on market demand, transportation costs of the commodity and various other factors.

Depending on an entity's risk management objective, it may not want to hedge the market price of the commodity but may still wish to hedge the fixed basis differential, seeking the most beneficial basis differential. By hedging this component separately, entities can more precisely manage and mitigate this specific risk. The restriction arises because the contract does not hedge the entire variability in cashflows, but only the portion that is related to the basis differential. This can pose significant challenges for entities looking to hedge their commodity price risk effectively for mixed-attribute contracts.

These issues could be resolved by a broad project to re-assess the existing hedge accounting model under ASC 815. For example, there is guidance under IFRS that allows any specified risk component of a financial or non-financial item to be eligible for hedge accounting as long it is separately identifiable and reliably measurable.

## CONCLUSION

In recent years, the FASB has continued to make targeted improvements to the derivatives and hedge accounting model (eg, ASU 2017-12), and has other projects on its technical agenda, including ASC 815: Derivative Scope Refinements and ASC 815: Hedge Accounting Improvements. As this paper explains, there remain several issues with the hedge accounting model today that significantly restrict the types of eligible hedge strategies and the portions of the balance sheet that are eligible to be hedged.

Some of these issues could be addressed as part of targeted narrow-scope projects. For example, an emerging issue task force project could be initiated to assist in the review of the ability to hedge interest rate risk on HTM securities, the issue of hedging forecasted purchases and issuance, or the hedging of FX risk in foreign currency-denominated financial assets or liabilities.

Given the technical and complex nature of these issues, a more holistic review of the hedge accounting model may be more appropriate than a step-by-step approach. Without a more holistic review of the technical and operational challenges that are restricting the ability of entities to apply hedge accounting in line with their risk management objectives, there will continue to be tension in how the accounting guidance influences decisions regarding whether or not to transact risk-reducing derivatives.

## APPENDIX: BACKGROUND ON DERIVATIVES AND HEDGING

### Background

Entities across industries apply hedge accounting under ASC 815: Derivatives and Hedge Accounting, to manage a wide range of risk exposures. While ASC 815 provides a useful framework to achieve hedge accounting, there are situations in which entities either may not or are not able to use hedge accounting to mitigate certain exposures. This is due to prohibitions in ASC 815, or technical challenges in applying it, and consistent or inconsistent interpretations of technical accounting requirements among audit firms that effectively prohibit certain hedge strategies for all or some preparers.

This paper explores the challenges faced by financial and non-financial institutions that seek to apply hedge accounting. In particular, it focuses on the pervasive challenges faced by entities that are exposed to interest rate risk, FX risk and other select risks such as inflation risk, but are unable to achieve hedge accounting.

The paper first provides an overview of the derivatives accounting model and hedge accounting model under ASC 815 as background information and then explores the challenges in applying hedge accounting in certain circumstances, as well as the root causes and potential solutions to address the challenges.

Entities are exposed to a variety of risks that can affect their earnings and economic stability. The larger and more complex the entity, the greater the size and complexity of risks to which it may be exposed. For example, entities that issue or hold interest-bearing financial instruments are exposed to the effects of changes in interest rates, which can change the fair value of a fixed-rate instrument or change the cashflows of a variable-rate instrument. Additionally, entities that transact in currencies that are different to their functional currency are exposed to changes in FX rates. Still further, entities may also be exposed to other risks, including inflation risk, pre-payment risk, credit risk and other market risks.

Each of these risks can have a significant impact on the operating results of an entity by changing the expected cashflows or the fair value of affected assets and liabilities. For example, entities commonly issue variable-rate debt instruments, which will affect the recognition of interest expense when there is volatility in interest rates. Similarly, entities that transact in foreign currencies are exposed to FX risk, which will create variability in the functional currency equivalent transaction costs as FX rates change. In the current state of the global economy, many corporations and financial institutions have significant exposures to FX risk due to their activities with customers, vendors and their own operations in foreign countries.

Entities commonly enter into derivatives to mitigate the risk exposure introduced by changes in interest rates and FX rates. A key feature of all derivatives is that they are financial instruments that reference an underlying, such as an interest rate index, FX rate, security price or other variable. Changes in the cashflows and/or the fair values of derivatives are driven by changes in the underlying.

Companies that issued variable-rate debt owe interest payments that will fluctuate with changes in the reference rate and may economically hedge this exposure by executing an interest rate swap in which the company receives a variable interest payment and pays a fixed interest payment. The net payment received or paid on the derivative economically offsets the variability in the interest rate payments due on an entity's debt.

The use of a derivative effectively fixes the amount of the interest payments. Depending on the risk management intentions of the entity, they may seek to lock in their exposure against the variable risks, or unlock the market risks related to fixed-rate instruments where they seek to be exposed to market interest rates.

## Economic Hedging vs. Hedge Accounting

When entities seek to hedge their risk exposures, they often enter into a derivative generating an offsetting risk exposure to economically reduce or eliminate the initial risk exposure.

If hedge accounting is not applied, the accounting may not reflect the mitigated risk exposure and the resulting income statement volatility could suggest to users that the risk is unhedged rather than hedged. For example, because derivatives are carried at fair value with changes recorded in earnings, the item generating the exposure (eg, debt) may be carried at amortized cost, resulting in a mismatch in timing and amount of each item's impact on earnings.

In this case, total changes in the fair value of the derivative will be reflected in earnings, while only the current period accrual of the hedged debt will be recorded in earnings. This accounting mismatch between the derivative and hedged item during each reporting period generates increased volatility in earnings, although the exposure has been hedged economically.

While it may appear that a fair value election for the hedged exposure could eliminate this accounting mismatch, not all hedged exposures are eligible for a fair value election. In addition, the application of a fair value election can create other accounting mismatches that can also confuse the communication with users of financial statements.

Alternatively, if hedge accounting is elected and the criteria to apply hedge accounting are met, the accounting for the derivative and the hedged item can be better aligned, either from an accounting basis perspective or a timing perspective, to not only mitigate an economic risk, but also to effectively communicate through the income statement that such risk has been mitigated.

This improved alignment between economics and accounting generates a strong incentive for entities to apply hedge accounting to manage risks and better capture the economics of their risk management activities in the financial statements.

Entities manage their risks by entering into various hedge accounting strategies. The hedges are classified as fair value hedges, cashflow hedges, foreign currency hedges or net investment hedges of foreign operations. The benefits of these hedge accounting strategies are significant, as they allow institutions to mitigate exposure to volatility in cashflows or earnings. These hedge strategies, when properly implemented, can contribute to the overall financial stability of the institution and can provide safeguards against market conditions that could, if unmitigated, lead to financial distress or failure.

## Fair Value Accounting

Derivatives are always accounted for at fair value, with changes recorded in earnings when hedge accounting is not applied. Changes in the fair value of a derivative are primarily driven by the underlying variable in the derivatives contract, such as an interest rate or FX rate index.

Under ASC 825: Financial Instruments, entities are permitted an irrevocable option to elect to account for financial instruments at fair value. From an economics and accounting perspective, if both the derivative and the hedged item are accounted for at fair value, the changes in fair value of each instrument recorded in earnings in each period should eliminate the accounting mismatch (timing difference).

However, fair value accounting is not the appropriate measurement for all financial instruments. For example, deposits held by a bank are interest-bearing liabilities that expose the bank to interest rate risk. Deposits have no stated maturities, so the fair value under US GAAP would equal the carrying value, since the amounts are payable on demand.

However, banks model the fair value of deposits using maturity assumptions that are often multiple years longer than the same-day US GAAP maturity. This inability to align the maturity for risk purposes with the prescribed maturity for US GAAP purposes limits the ability to use the fair value option or fair value hedge accounting for a significant source of interest rate risk on a bank's balance sheet.

Another challenge with fair value accounting is the need to include credit risk and other market factors under ASC 820: Fair Value Measurement, which risks the entity not seeking to hedge. Mitigants for those risks are often not present in the interest rate-related derivatives transaction. Specifically, an entity must include the impacts of counterparty credit risk in the fair value measurement, when such risk is not intended and in many cases is unable to be hedged.

Entities that apply hedge accounting are typically seeking to isolate and manage a specific risk exposure. For example, interest payments on debt instruments are usually comprised of a benchmark interest rate plus a credit spread, which is determined based on the creditworthiness of the borrower. When hedging interest rate risk on debt, companies typically hedge only the benchmark interest rate risk and not the credit spreads. Hedge accounting provides a tool to entities to isolate and manage the specific risks to which they are exposed.

## Overview of the Derivatives and Hedge Accounting Models

### General Derivatives Accounting Model

Derivatives are always carried at fair value on the balance sheet as either an asset or a liability. Accordingly, a question arises over where the changes in fair value of the derivative are recorded. If the derivative does not qualify as a hedging instrument under ASC 815, the change in the fair value of the derivative is always immediately recorded in earnings. If it does qualify as a hedging instrument, the change in the fair value of the derivative could either be recognized in earnings, OCI, or as part of the cumulative translation adjustment in OCI, depending on the applicable type of hedge accounting.

### Hedge Accounting Model

Under ASC 815, several risks are eligible to be hedged, including market price risk (total changes in fair value), interest rate risk, FX risk and credit risk. Depending on the nature of the hedged item (ie, fixed or variable cashflows), derivatives can be designated as accounting hedges either as fair value hedges, cashflow hedges or a net investment hedge.

Fair value hedges reduce the exposure to changes in the fair value of an asset or liability related to the designated risk. For instruments that qualify as fair value hedges, the gain or loss on the derivatives instrument included in the assessment of hedge effectiveness, along with the offsetting gain or loss on the hedged item attributable to the hedged risk, is recognized in earnings in the current accounting period. As a result, any difference between the changes in the fair value of the derivative and the hedged item is realized in earnings.

Cashflow hedges reduce the exposure to the cashflow variability of an existing asset or liability or of a future/forecasted transaction. For derivatives that qualify as cashflow hedges, the entire change in the fair value of the hedging derivative included in the assessment of hedge effectiveness is reported as a component of OCI, and is reclassified into earnings in the same future period or periods during which the hedged forecasted transaction affects earnings.

Net investment hedges offset the foreign currency exposure created by a net investment in a foreign operation. For instruments that qualify as hedges of a net investment in a foreign operation, the entire change in the fair value of a hedging instrument included in the assessment of hedge effectiveness is reported in OCI as part of the cumulative translation adjustment until the hedged net investment is sold or liquidated.

For all three types of hedge, any amounts excluded from the assessment of hedge effectiveness are recognized in earnings through an amortization approach, unless the entity makes an accounting policy election to immediately recognize the change in the fair value of any excluded components in earnings.

## Requirements and Challenges to Achieve Hedge Accounting

In 2021, the FASB requested feedback from market participants on its future standard-setting agenda. Market participants, including ISDA's North America Accounting Committee, highlighted a variety of issues and challenges within the hedge accounting model that could be clarified through standard-setting activity.

Since the consultation, the FASB has taken on narrow-scope projects to improve ASC 815 by addressing targeted issues. While the market has welcomed these improvements, there is a broader need to modernize the hedge accounting framework to improve the accounting model in ways that will enhance risk management.

In its 2021 Agenda Consultation Report<sup>1</sup>, the FASB expressed its openness to broad changes in the hedge accounting framework, specifically demonstrated by the acknowledgment of stakeholder feedback to bring further alignment of hedge accounting with risk management activities beyond the targeted improvements made to the hedge accounting model in ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.

The FASB also demonstrated its openness to stakeholder feedback to undergo larger projects such as the Hedge Accounting Phase 2 research project, which was expanded to consider changes to the definition of a derivative, including exploring a broader reconsideration of the definition of a derivative. The report noted that 10% of all respondents cited this research project as an area the FASB should prioritize.

However, the scope of the hedge accounting project, while expanded to a number of issues, is targeted at specific issues within ASC 815 rather than a holistic review of the hedge accounting framework. A broader improvements project could more completely address all of the current limitations entities face in applying hedge accounting to better align with their risk management needs, and address the interactions of the guidance as applied to different types of hedges.

ISDA has explored how the prescriptive guidance under ASC 815 can result in different accounting interpretations from auditors, impose operational burdens on entities and be unnecessarily restrictive on certain hedging strategies for interest rate risk, FX risk and other select risks.

<sup>1</sup> 2021 FASB Agenda Consultation Report, Financial Accounting Standards Board, [fasb.org/Page/ShowPdf?path=2021%20FASB%20Agenda%20Consultation%20Report.pdf&title=2021%20FASB%20Agenda%20Consultation%20Report](https://www.fasb.org/Page/ShowPdf?path=2021%20FASB%20Agenda%20Consultation%20Report.pdf&title=2021%20FASB%20Agenda%20Consultation%20Report)

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Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In

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