

**ABI Position paper**  
**“Exposure Draft Hedge Accounting”**  
March 2011

Dear Sir/Madam,

We appreciate the opportunity to comment on the Exposure Draft Hedge Accounting published by the Board.

We are aware that Board must meet two goals with the ED: align hedge accounting standards with risk management practice adopted by the entity while, at the same time, avoid manipulation of the financial statements by un-orthodox strategies that, even if documented, are aimed only at altering P&L results.

In this context, we appreciate the work that the Board has done. The Italian banking industry believes that a complete alignment of accounting standards to risk management is paramount for a meaningful translation into the financial statements of what is actually performed to preserve both the economic value of the business and earnings stream.

Notwithstanding this, as a banking association, we have to withhold our final judgment until the topic of macro-hedge will be fully reviewed.

Our main concern relates to the fact that since the Macro hedge standard could probably be built around the principles set-up by the ED, the treatment of sight deposits and of basis risk and prepayment risk (which within the current standard entail the maintenance of the so-called carve out version) may not be in line with the risk management practice. In such a case, banks would continue to artificially designate hedging relationships which are meaningless from a risk management viewpoint.

These issues have not been dealt with in the ED but they are a top priority for a meaningful management of the interest rate risk of the banking book.

Having said that, we would like to state as follow:

First, we support the decision to allow the designation as hedged item of net position and layer of groups of items.

We recommend applying this framework also to Fair Value Hedges of Portfolio of financial assets (also called macro hedge) as it would solve much of the complexities associated with current, non carved-out versions of IAS 39. In this respect, as risk management approach is to hedge open portfolios whose composition may vary on a daily basis, the new standard shall not require tracking every single position of the hedged portfolio.

In order to address this issue, we think that strict requirements have to be introduced. For instance it would be compulsory to test that, at the end of each

reporting period, the risk of the hedging instruments is lower than the risk of a designated layer of the hedged open portfolio.

Second, there is the need to clarify the treatment of sub-Libor term and sight liabilities. In our opinion, the possibility to hedge these kinds of liabilities is still unclear.

Accordingly, we would recommend an explicit statement by the Board.

In this context it has to be emphasised that in order to achieve the alignment between risk management activities and accounting it is important not to limit (by rules only) the hedgeable items as it could have very significant impacts.

Under current IAS 39, the prohibition to hedge, accounting wise, certain items that are effectively hedged by bank's risk management practice has forced banks to look in their balance sheet for items that could qualify as hedgeable.

As a result, cash flow hedges of liabilities have been represented as Fair Value Hedges of assets or vice-versa.

It is our understanding that, the ED wants to avoid such practice by linking the hedge accounting to risk management.

However this rule might determine the classification as trading of derivatives entered into for hedging positions not qualifiable as hedged items.

Finally, we note that a closer alignment between the risk management practice and the ED might be achieved by addressing some points that we have raised in the specific questions. We also highlight that a tight alignment between Risk Management and Accounting would allow the accounting standard be aligned with the requirements of Basle 3 as well. Such an approach would definitively close the potential loopholes that the current rules-based IAS 39 and proposed ED still leave unscathed.

**Question 1**

**Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?**

We agree that the objective of hedge accounting should be the representation of the risk management activities pursued by the entity.

For this reason, we would like to draw your attention to our answers to the document in full.

In addition, please take note of our introductory remarks concerning Fair Value hedges of (open) portfolio of financial instruments.

Finally we would like to draw your attention to the fact that the standard does not allow hedging equities that on initial recognition are designated at fair value through OCI. In general, we do not believe that hedge accounting should be restricted to risk that affects profit or loss.

We fail to see the rationale behind this decision other than the fact that this hedge may contradict some principles embedded in the standard or in IFRS 9. Currently, strategic investments and equity instruments classified in the AFS category are effectively hedged by means of option contracts.

Accordingly such prohibition is actually contradicting the core objective of hedge accounting as it would not allow a proper representation of risk management activities pursued by the entity.

Respecting this core objective should be given more priority than other principles underlying the standard.

In this context, a possible solution that we would recommend is to review IFRS 9 in order to allow the recycling to P&L of AFS reserve upon sale of the equity instrument.

Recycling would require the rule for impairment test being introduced.

In this case an IAS 36 based test would be the most appropriate solution considering the “strategic nature” of such investments.

**Question 2**

**Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?**

We generally agree.

As for designation, we note that the ED does not allow derivatives embedded in financial assets to be designated as hedging instruments; according to the proposal, hybrid instruments may be designated as hedging items only in their entirety.

This clearly results in a mismatch between hybrid assets whose embedded derivatives cannot be designated as hedging items and hybrid liabilities whose embedded derivatives may be designated as hedging items.

In this context, we cannot see the reason why the same embedded derivatives can be designated as hedging instruments if embedded in financial liabilities but not in a financial asset.

Possible solutions are either:

- 1) to revise IFRS 9 in order to allow classification of hybrid instruments at amortized cost with bifurcation of the embedded derivative or
- 2) use current rules to be used for bifurcation of hybrid liabilities in order to identify the derivative embedded into a FVTPL hybrid asset that may be designated as hedging instruments.

We would prefer solution 1) for the reasons discussed (see ABI comments on IFRS 9).

### **Question 3**

**Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?**

We agree with the proposed ED.

### **Question 4**

**Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?**

We agree, in principle, with the proposed ED.

However we note that the ED states that Inflation risk is not, unless contractually specified, a hedgeable risk.

In our opinion, considering the relationship between nominal interest rate and inflation rate, it could constitute a “non-contractually specified risk component” of nominal interest rate and thus qualify for hedge accounting if all other requirements of the standards are met.

As drafted in the ED, the proposal seems rule-based rather than principle-based and:

- might raise doubts about the actual meaning of “separately identifiable” requirement
- might be inconsistent with the general objective of the standard if an entity has the practice of hedging its inflation exposure for risk management purposes.

In this light, we also consider the issue of negative margin (i.e. sub-Libor issue) and the credit spread.

As mentioned in the introduction, hedging sub-Libor demand deposits is an essential theme for removing the actual carve out.

#### **Question 5**

**(a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?**

We agree with the proposal to allow the designation as hedged item of a layer of the nominal amount if such designation is consistent with the risk management practices followed by the entity.

**(b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option’s fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?**

We don’t agree that a layer component should not be eligible as a hedged item in a fair value hedge if it contains a prepayment option and the option’s fair value is affected by changes in the hedged risk.

We note that Interest bearing instruments containing prepayment option’s might be effectively hedged, according to common risk management practices, through combination of:

- IRS and/or swaptions and/or
- IRS having a maturity equal to the expected maturity of the hedged layer (underhedge).

Alternatively, only part of the items composing the group of hedged items might have prepayment options (while all of the instruments are exposed to interest rate risk). In this case, it would be possible to designate as hedged exposure only the part of the portfolio not including the prepayment option.

**Question 6**

**Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?**

We agree that hedge accounting should be proven to minimize expected hedge ineffectiveness and thus minimizing P&L effects.

In particular, we agree with the principle in par. B32 which establishes that hedge effectiveness shall be only forward looking.

We agree with the decision of eliminating the bright line of 80-125% and replacing it with an objective-based assessment. Some clarification of the meaning behind “unbiased results” is welcome, though.

**Question 7**

**(a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?**

**(b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?**

We agree. The approach of current IAS 39 is rigid and doesn't reflect risk management activities. Risk management is a dynamic activity and, in order to represent risk management activities, a flexible approach as the one proposed in the ED is necessary for adjusting a continuing hedging relationship.

Moreover banks' activities require a certain level of flexibility that ensure consistency with actual risk management and the ED should require only significant rebalancing process (about circumstances and frequencies of rebalancing).

It may also be useful to clarify that the habits to replace internal or intercompany hedging derivatives with external ones might be qualified as rebalancing.

**Question 8**

**(a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?**

**(b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?**

It is our understanding that according to the proposal an entity is permitted to discontinue hedge accounting only when:

- hedging instruments are derecognized or
- the relationship doesn't comply with the risk management strategy of the entity or
- the relationship, while still complying with the risk management strategy of the entity, is unable to meet the effectiveness requirements.

We agree with the proposal, provided that rebalancing includes the replacement of internal derivatives with external ones. However, it is not clear the extent of the difference between rebalancing and de-designation.

#### **Question 9**

**(a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?**

We agree with recognition of the ineffectiveness portion of the hedge accounting in P&L; however, we see no point in changing current treatment and thus recognizing the effective change in fair value of the hedged item and hedging instruments in OCI rather than in P&L.

This change does not seem to be a clear improvement in the accounting treatment of hedge relationships and would split the presentation of the overall effect of fair value hedges between OCI and P&L, in contrast to what is set out in BC123 (c).

In addition, we would like to draw your attention to the interaction between the ED and the project on Other Comprehensive Income.

We have noted that the ED uses OCI more for recognizing income and expense. Considering that the Board intends to merge P&L and OCI into a single statement, we believe it is very important to clarify the rationale underlying the use of OCI which currently is unclear.

This is in particular important considering that the treatment envisaged for Cash flows hedges leads to volatility in OCI and thus of the "bottom line" of the statement of comprehensive income that will replace P&L shortly.

**(b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?**

The proposal has the benefit that the hedged item would be presented at amortized cost (i.e. the measurement criterion that would have applied considering the reclassification provided that hedge accounting didn't apply).

However it presents the following drawbacks:

- the whole accounting value of the instrument would be split in the balance sheet between two line items;
- it may lead to some complexity as hedge accounting revaluation has to be managed and accounted for together with the hedged item (i.e. it has to be amortized by changing EIR in case of discontinuation and it has to be derecognized in case of derecognition or impairment of the hedged instrument);
- it could introduce a great number of line items presented in the statement of financial position. The number of the lines will depend of course by the schemes that the different regulators/association might requires or suggest. As Italian Banking Association, we think that the number of possible line items could be comprised between two (one for assets and one for liabilities measured at Amortized cost) and six (if the amortized cost category is split according to current regulatory requirements in loans to bank, loans to customer and securities on asset side and due to banks, due to customers and debt securities on liability side).

As regards hedging of a net position including assets and liabilities, the split presentation on both sides of the financial statement could be artificial and complex.

As for this topic, we neither agree nor disagree.

**(c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?**

We agree that linked presentation should not be allowed because it doesn't increase information but leads to more confusion.

#### **Question 10**

**(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general**

**requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?**

**(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?**

**(c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?**

We agree with the principle that time value of the option should be treated as the insurance premium paid by the entity performing the hedge.

However, we believe there is a need to clarify the definition of "transaction related item" as the definition provided by paragraph B67(a) seems inadequate. In our opinion, it is not the hedged item (forecasted purchase/ sale or firm commitment) that has the nature of transaction cost but it is the time value component of the premium paid that has such nature.

Finally we don't agree with the fact that accounting for Time Value of option should apply only to the extent that time value relates to the hedged item.

In our opinion, the treatment of time value should follow the treatment of the whole option.

Accordingly, if the whole intrinsic value is designated as hedging item and this designation fulfills the hedge accounting requirements as:

- it is compliant with the risk management activities of the entities
- it minimizes ineffectiveness, doesn't produce biased results and the offsetting is not accidental then the whole time value should be accounted for in accordance with paragraph 33.

In fact, such time value should be considered as the "insurance premium" of the option contract which most closely mirrors the hedged item.

#### **Question 11**

**Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?**

We welcome the changes made to hedges of group of Items and in particular the possibility to hedge net positions as well designate a layer of the group as hedged .

We recommend applying this possibility also to Fair Value Hedges of Portfolio of financial assets (also called macrohedges) as it would solve much of the complexities associated with current, non carved-out versions of IAS 39.

In this respect, we believe that the requirements (established in paragraph B22) to track the whole items (and not only the hedged layer) to which the fair value adjustment relates shall not impact the treatment of open portfolios subject to macrohedging techniques.

Having said that, we do not agree in limiting this possibility to open portfolio (i.e. an open portfolio today could be a close portfolio in the future).

Risk management approach for hedges of portfolio composed of interest bearing assets and liabilities (i.e. fixed rate and floating rate loans/bonds, on demand deposits), non-interest bearing assets and liabilities (i.e. premises and equity) is to hedge open portfolios whose composition may vary on a daily basis due to the origination activity performed, redemptions, prepayments or impairment.

Mentioned changes in the hedged portfolio are hedged by a continuous “rebalancing” of the hedging derivatives in order to match, as closely as possible, the composition of the hedged portfolio.

In this situation the requirements to track and measure at fair value all the items constituting the open portfolio associated with the hedged layer would be burdensome as it would, for instance, require the split of the open end portfolio in several closed ended portfolios to track the events which may occur.

In order to address this issue, proxies have to be introduced for macrohedges. For instance, by comparing that, at the end of each reporting period, the risks of the hedging instruments are lower than the risk of a designated layer of the hedged open portfolio. Furthermore it is necessary a consistency between the notion of ineffectiveness for the purpose of assessing/designating a hedge relationship (eg. for risk management purpose the hedge is considered 100% effective) and the ineffectiveness that is required to be reported in profit or loss. Of course this proxy would entail that the hedged layer has been outstanding for an amount of time equal to the hedging items.

However considering both the number of items constituting such open portfolio and the fact that such assessment will be conducted at least twice a year, it would not be a far-fetched assumption.

In addition, we note that the ED might still impact some issues on the matter of hedging sub-Libor instruments (par. B24).

In fact according to the ED sub-Libor, instruments having a maturity (i.e. not “on demand”) seem hedgeable both on individual and on a group basis provided that the entity chooses an hedge ratio which minimizes the ineffectiveness and doesn’t produce biased results.

However it must be clarified whether sub-Libor liabilities on demand (i.e. demand deposit):

- 1) are not hedgeable at all or
- 2) might be hedged provided that some disclosure is being released.

The crucial issue, in this context, is whether the current assumption will be kept that the FV of demand liabilities is equal to the amount payable on demand .

We reiterate that portfolios of demand liabilities might be statistically considered as financial liabilities instruments having a maturity (akin to ZC Bonds) and are managed this way for risk management purposes. Accordingly, the hedge of such position is compliant with the core principle of the ED (i.e. representing the risk management activities performed by the entity).

Accordingly these kinds of liabilities should be hedgeable both for macro hedges and for (micro) “closed ended” group-of-items hedging.

Given the relevance of this subject for the entire banking industry, a positive clarification seems however necessary in order to avoid any misunderstanding.

#### **Question 12**

**Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?**

We are concerned that the proposed rules might have unintended effects.

For instance, please consider the hedge of a financial asset and liability through an IRS that is to be accounted for as a 100% effective Cash Flow Hedge.

In such situation:

1. Assets and liabilities are not re-measured and associated income and expenses are recognized in separate P&L line items (interest income and interest expenses)
2. The derivative is measured at fair value with changes recognized in OCI
3. Due to the passage of time, a part of the recognized Cash Flow hedge reserve is recycled to P&L.

According to the current rule, the recycling mentioned in point 3. is recognized as interest income or interest expenses thus stabilizing the interest margin.

According to the new rule, the recycling would create a new P&L line. Currently, as regards Italian banking system, this kind of information is already provided through disclosure. In order to avoid the creation of multiple line items in the Income statements, we recommend retaining only a disclosure requirement without affecting the main schemes.

### **Question 13**

**(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?**

**(b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?**

We generally agree with the disclosure proposed.

However, it is our understanding that the information required on the amount, timing and uncertainty of future cash flows (paras. 45 – 46) might constitute an overlap of information currently required by IFRS 7 for liquidity and market risk which disclose entity's net positions after taking into account all the hedges.

### **Question 14**

**Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?**

We have no comment on this issue.

### **Question 15**

**(a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?**

**(b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?**

We note that representation in financial statement of the economic hedge of credit risk is an important topic for banks and constitutes an important drawback of current IAS 39.

Given this premise, we urge the Board to solve current impossibility to recognize the accounting effect of this kind of hedge relationship.

In our opinion, the preferred alternative, among those presented, would be the third because:

- it allows the accounting for the economic effect of Debt Instruments plus a CDS *after* initial recognition of the debt instruments thus recognizing the possibility that hedge of credit risk may occur after initial recognition of the instrument
- it avoids the immediate recognition of the change between Amortized cost and fair value, thus reducing P&L volatility and opportunities for earning managements.

However, we note that Alternative 3 would avoid P&L volatility only if the debt instrument is hedged for all risks (i.e. against Interest Rate Risk *and* credit risk).

Given this premise, in our opinion, the hedge of credit risk could be better dealt with by referring to the principles already in the ED.

In fact, CDS as hedging instruments:

- are an effective tool used by risk management strategy and
- meet, if properly used, the hedge effectiveness requirement (in the sense that the hedge relationship produces unbiased results and achieves other than accidental offsetting between the debt instruments and CDS).

In this context, by reading the Basis For Conclusion, we understand that in the Board's view, Credit risk cannot be hedged because it is not considered a separately measurable risk component.

However, we note that it is common practice for Level 2 debt instruments to measure fair value by referring to the CDS quotes of counterparty credit risk.

We note that such behavior has been also somewhat endorsed by IASB.

In this context, please refer to:

- Par. 51 of IASB EAP document "Measuring and disclosing FV in markets that are no longer active which states "*Credit default swap (CDS) indices might be used to evaluate movements in corporate credit spreads when measuring the fair value of a corporate debt instrument for which an entity's credit spread information is not available*"
- Par. 75 of the same document which states "One component of the fair value of an entity's financial liabilities is the credit spread that market participants would require to take on the credit risk of the instrument. There are various potential sources for reflecting own credit in the valuation of liabilities. These include, for example, the senior debt issue

- curve of the entity, credit default swap spreads, structured loan note issue curves and asset swap spreads”
- Examples 12 and 13 of the Staff Draft “Fair Value Measurement” which requires , for fair value calculation, the analysis of changes in credit spread. The analysis portrayed by the examples implies referring to CDS quotes.

Accordingly, we cannot understand why CDS might constitute a reliable source of information for measuring fair value (and thus credit risk) of a financial instrument but can't be used as hedging instruments.

In our opinion, it could make more sense to consider credit risk a contractually unspecified component. Any possible differences between the actual hedged credit risk and the change in FV of CDS (attributable to derivatives' counterparty risk or the difference between the terms reference obligation and the hedged item) should be dealt through estimation and recognition of ineffectiveness.

This would achieve a better presentation than recognizing the full change in the fair value of the hedged items against the change in fair value of the CDS.

A possible alternative to hedge accounting would be to apply an insurance based model by considering CDS like insurance contracts and thus amortizing the cost of the hedge along the life of the hedge.

This could require a broader definition of financial guarantee in order to identify which contractual conditions might satisfy this definition.

#### **Question 16**

**Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?**

We agree. In our opinion, the whole IFRS 9 package (Classification and measurements, Impairment and hedge accounting including macrohedge) should be adopted simultaneously.

Considering the analysis and changes likely to be required by the final standard, we estimate a First Time Adoption for 2015 Financial Statements.