01 March 2011

Our ref: ICAEW Rep 22/12

Mme Françoise Flores
Chair
European Financial Reporting Advisory Group
13-14 Avenue des Arts
B-1210 Brussels

Chère Mme Flores

ED/2010/13 *Hedge accounting*

MAJOR POINTS

Our overall view on the proposals

1. ICAEW welcomes the opportunity to comment on EFRAG's draft comment letter, published in January 2011, on the International Accounting Standards Board Exposure Draft ED/2010/13 *Hedge accounting.* Our responses to the main issues highlighted by EFRAG are set out below. A draft of our response to the IASB, which has not yet been finalised, is attached to this letter.

2. We second EFRAG's support for the IASB's decision to develop a new hedge accounting model to replace the existing requirements of IAS 39. We welcome the proposed replacement of the existing approach with a more principles-based one, with a stronger link to the underlying risk management strategies of the reporting business.

3. In our view, the key to making the proposals work is establishing the right linkage between risk management strategy and hedge accounting. We support the proposal that the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities. In our view, the individual accounting hedges in aggregate at the level at which the risk is managed, should reflect the application of the overall risk management strategy as documented by the entity and as reported to and reviewed by senior management for risk management purposes. This will naturally vary between different entities depending on their management structures and the nature of the risks being managed but typically risk management objectives will be set at an entity-wide level, a business unit level, a portfolio level or some other lower level. The concept should be consistent with the determination of the business model in IFRS 9, which is not at an individual instrument. Properly articulating the link at the right level is particularly important to make sure aspects of the proposals such as rebalancing are to work as intended.

Our thoughts on EFRAG's high level comments

4. We agree that the proposed hedge accounting model provides a number of significant improvements that will make hedge accounting more flexible and therefore more accessible. In doing so the IASB will allow entities to better align their accounting with their risk management objectives and so facilitate more meaningful and understandable accounting and disclosure.

5. We agree that the proposals introduce new complexities, particularly in relation to rebalancing and the accounting for the time value of options. Our representation letter therefore includes suggestions for reducing the potential burden without undermining the objectives.

6. We agree that informative disclosures are necessary as the proposals will introduce significantly more judgement than was the case under IAS 39. Like EFRAG, we support the proposed disclosure objectives but we have concerns about the detailed requirements.

7. We agree that there are interdependencies between the various phases of the project to replace IAS 39 and other ongoing IASB projects. Although we have not raised this issue in our response to this particular exposure draft, we have done so when responding to the IASB's *Request for Views on Effective Dates and Transition Methods*.

8. We consider that the IASB should proceed with these proposals, which represent improvements to existing hedge accounting requirements, as a priority to achieving convergence with the FASB.

9. We share EFRAG's concerns about many of the issues listed in your draft letter as requiring further consideration. See 'notable differences of opinion' below for details of items where we disagree or do not share EFRAG's concerns.

10. We agree that further field testing and outreach activity would be beneficial to ensure that the proposals can be operationalised.

11. We agree that the IASB should not finalise a standard on hedge accounting until it has models in place for both general and macro hedging.

12. We are supportive of many of the views put forward by EFRAG on the specific questions raised by the IASB in their exposure draft. More details are provided below where our opinions differ.

NOTABLE DIFFERENCES OF OPINION

Risk components

13. Like EFRAG we welcome the proposals to allow the designation of a risk component as a hedged item if it is separately identifiable and measureable. We also agree that there is no conceptual reason why non-contractually specified inflation cannot be designated as a risk component.
14. However, we would clearly include in the principle that **all** risk components are to be eligible hedged items provided that they are separately identifiable and reliably measurable. In our view, any specific exclusion from this principle is unwarranted as it would prohibit hedge accounting for some valid risk management strategies. This is in keeping with developing a principles-based, rather than rules based, standard.
15. In addition to non-contractually specified inflation risk we also raise specific concerns about the IASB's proposed restrictions on designating prepayment risk and credit risk as hedged items.

Rebalancing

16. In principle we agree with the notion of 'rebalancing' as it enables entities to reflect changes made to the hedge ratio for risk management purposes in their accounting. However, in our view rebalancing should be optional rather than mandatory.

17. We have a number of concerns about mandatory rebalancing of hedging relationships.

    - We do not believe an entity should be forced to rebalance a hedging relationship if doing so is not a part of its risk management strategy. This is inconsistent with the aim of better aligning accounting with risk management objectives.

    - In some circumstances it may not even be possible to rebalance eg, where the hedge is of a very specific risk and the entity is not be able to contract further hedging instruments. If

rebalancing is not possible and the hedge accounting is still consistent with the risk management objective, then it is not clear how the requirement could be met.

- It is a matter of judgement whether the risk management objective has changed or not, meaning there will be no ‘right answer’ when it comes to deciding whether rebalancing should take place or the hedging relationship should be discontinued.

- Some entities may interpret the proposals as meaning that the hedging relationship must be 100% effective at all times, meaning they would feel the need to constantly rebalance in order to continue applying hedge accounting. This would greatly increase the complications of tracking and managing the different layers of hedge accounting.

- If rebalancing requires additional market transactions rather than merely changing the designation of proportions if the hedging instrument, the additional costs would made this unattractive.

For these reasons, we believe that rebalancing should be optional.

18. We believe that even if the hedge ineffectiveness is outside of management’s normal tolerance levels there should be no mandatory requirement to rebalance.

Voluntary de-designation

19. Voluntary de-designation is currently permitted by IAS 39 and in our opinion should continue to be permitted. Since the future cannot be predicted, we do not believe that, in practice, discontinuing hedge accounting can be used to achieve a particular accounting result.

The time value of options

20. Where an entity elects to designate only the intrinsic value of the option as the hedging instrument under IAS 39, the time value of the option is classified as held for trading and is therefore measured at fair value through profit or loss. We accept that doing so can give rise to significant volatility in profit or loss and that this accounting treatment is disconnected from the entity’s risk management strategies. Nonetheless, given the complexity of the alternative proposed within the exposure draft, we feel that entities who wish to continue with the existing IAS 39 approach should be allowed to do so. In other words we would not mandate the proposed change but include it as an alternative to the existing IAS 39 approach.

21. We believe that the proposed approach, while theoretically sound, is complex in practice and would support efforts to reduce the complexity, recognising that the notion of the time value of an option that perfectly matches the hedged item is not dissimilar to a hypothetical derivative. It may be that the perceived complexity of the approach can be reduced by building on the existing practice for hypothetical derivatives.

RESPONSES TO SPECIFIC QUESTIONS RAISED BY EFRAG

EFRAG question 1
Do you believe there is in effect an inconsistency between (i) the irrevocable designation of a financial instrument as at fair value through profit or loss and (ii) hedge accounting that may be discontinued if that is in accordance with an entity's risk management strategy?

22. We do not agree.

23. Under IFRS 9 an entity may irrevocably elect on initial recognition to measure a financial asset at FVTPL only if that designation eliminates or significantly reduces an accounting mismatch had the financial asset been measured at amortised cost. While we accept that in some instances this may at some point in the future leave the entity with an asset measured at FVTPL even after the source of the mismatch has disappeared, we believe that the existing approach is appropriate as allowing entities to undesignate items held under the fair value option would create earnings management opportunities.

EFRAG question 2
Do you have any concerns regarding inflation as a non-contractually specified risk component of financial instruments? If so, please provide examples.

24. Like EFRAG we do not agree with paragraph B18 which states that 'inflation is not separately identifiable and reliably measurable and cannot be designated as a risk component of a financial instrument unless it is contractually specified'. In our view, inflationary risk should be treated in the same way as any other risk component ie, if an entity can demonstrate that it is separately identifiable and reliably measurable, it should be eligible to be designated as a hedged item.

EFRAG question 3
Do you have concerns with the issue of sub-LIBOR within the context of the general hedging model, i.e. hedges of individual items or closed groups of items (excluding macro hedging)? If so, please provide examples to substantiate you concerns.

25. Like EFRAG we have concerns about the sub-LIBOR issue. While this is particularly important in the context of macro hedging, it should not be overlooked in the context of individual items or closed groups.

EFRAG question 4
EFRAG understands from its initial consultation activities that, while the proposals are considered appropriate for single items, it may not be the case for prepayment options in the context of portfolios. We understand that, at a portfolio level, it may be possible to separately identify the risk component and facilitate the measurement of hedge effectiveness. Do constituents agree this assessment? If so, please provide examples of the instances where an alternative treatment is appropriate.

26. We believe that layer components that include prepayment options should be eligible hedged items even for single items. As noted above, we believe that all risk components should be eligible hedged items provided that they are separately identifiable and reliably measurable.

27. We agree that this is a more significant issue in the context of macro hedging. Further consideration needs to be given to whether this restriction makes sense in the context of portfolios, particularly as the Board develops its proposals for macro hedge accounting.

28. It does not seem unreasonable that an entity should wish to hedge the bottom layer of prepayable items, knowing that there is little or no risk of prepayment in the layer because all

prepayments will occur from the top layer. Vanilla interest rate swaps may well be an effective hedge of this bottom layer and such an approach is widely used in practice. We encourage the Board to further investigate such risk management practices and to consider how best they can be reflected in hedge accounting to reflect not only the risk management but the economic behaviour of the portfolio.

EFRAG question 5
Do constituents believe that the proposed disclosures meet the objective of providing transparency into an entity's hedging activities?

29. We believe the overall aim of the disclosure requirements should be to enable users of the financial statements to understand the nature and effectiveness of an entity's risk management strategies and how they impact upon the financial statements. Therefore we broadly agree with the proposed disclosure objectives in paragraph 40. However, we do not believe these objectives will necessarily be met by simply requiring entities to comply with the list of disclosures that follow in paragraphs 44-52. The inclusion of such a detailed, prescriptive list of disclosures is likely to encourage a 'checklist' approach to complying with the requirements, possibly resulting in vast amounts of micro level detail at the expense of the macro level information that is of interest to most users. Furthermore, the disclosures already required by IFRS 7 should be borne in mind. Duplication should be avoided as should any attempt to increase the scope of risk disclosures to risks not included in that standard.

30. We believe that entities should be required to consider the level of detail necessary to satisfy the disclosure requirements and how much emphasis to place on each of these requirements as this would allow some flexibility and ease the reporting burden in many cases. We would recommend that the Board should remove the word 'shall' from many of the proposed disclosure requirements and clearly state that all of the disclosures listed should not be regarded as mandatory in all situations.

EFRAG question 6
Do you believe the ['own use'] proposals will be useful in addressing problems in practice? If not please explain.

31. We support the proposals regarding the removal of the 'own use' scope exception that currently exists as part of IAS 39. Where an entity enters into a derivative contract to hedge exposures arising from 'own use' contracts as part of its risk management strategy we see no reason why hedge accounting should not be available providing the normal hedge accounting criteria are met.

EFRAG question 7
From its initial consultation activities, EFRAG has understood that [the 'own use'] issue may be broader than what the IASB had considered in finalising the proposals in the ED. Are there any other issues with the 'own use' exception that you are aware of? If so, what solution you believe would be appropriate to resolve the issue(s)

32. No.

EFRAG question 8
When economic hedges of credit risk do not qualify for hedge accounting for the sole reason that the credit risk component cannot be reliably measured, the IASB has considered, but rejected, accommodating hedge accounting using an alternative method. Which of the three proposed alternative methods considered by the IASB do you believe would be appropriate and why?

33. We do not agree that a separate approach is necessarily needed for hedges of credit risk. While accepting that there are inherent difficulties in doing so in practice, we believe that the normal hedge accounting rules should be permitted provided that credit risk can be separately identified and reliably measured.

34. We are not supportive of developing a separate hedge accounting model specifically for situations where entities hedge credit risk using credit derivatives. We believe all hedging arrangements should be accommodated within either the general hedged accounting model or the macro hedge accounting model.

35. We believe that all of the options included in paragraph BC226 would add unnecessary complexity to accounting for financial instruments. However, if pressed, our preferred choice would be alternative 3.

Please contact me should you wish to discuss any of the points raised in this letter or the attached draft response.

Yours sincerely

Eddy James ACA
Technical Manager, Financial Reporting Faculty
T +44 (0)20 7920 8701
E Eddy.James@icaew.com