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Comment letter to the Exposure Draft ED/2010/13 „Hedge accounting“

Dear sir David,

thank you for the opportunity to comment on the Exposure Draft (ED) on Hedge Accounting. We welcome the new principles for hedge accounting brought by the exposure draft (ED) which are much more focused on actual risk management practices. We appreciate especially simplifications in the area of testing the hedge effectiveness and allowing using the time value of the options for the hedges.

We understand why this ED does not contain regulation of macro hedges of interest risk at portfolio level. However we do not consider appropriate that the ED, for example IN 7, writes that only *closed portfolios (in which hedged items and hedging instruments can be added or removed by de-designating and redesignating the hedging relationship)* are in its scope. The intention here was probably to scope out the interest risk portfolio hedges.

But allowing only closed portfolio hedges is in direct contradiction to some parts of the ED which require or assume that hedged items or hedging instruments are adjusted during the hedges. This is typical for rebalancing, dynamic aspect is inherent in hedges of nil net positions, furthermore paragraph 27 mentions replacements or rollovers of hedging instruments. Therefore it would be better when the standard does not mention that only closed portfolios are in its scope and instead just lists the hedges for which it is not applied.

Below we give more detailed answers to the questions raised by IASB. Furthermore after the answers to the questions we include other issues which concern us and we would like to present our view. They discuss

- the Libor minus issue,
- time portions of hedging instruments and
- determination of the present value of the change in the hedged cash flows.

We kindly ask IASB to pay to them an attention which is equal to the official questions raised in the ED.

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?

Yes, we fully support objective of hedge accounting which is focused on representing the effects of risk management activities. However we would like to point to the fact that not allowing using of internal derivatives for hedge accounting introduces rather artificial elements when talking about actual risk management activities.

For clarifying this point we have to describe a general risk management model applied by banks. Risks for which application of hedge accounting risk is relevant are almost exclusively found in the banking book. Banking book generally contains non-speculative financial instruments which still carry some risks which need to be hedged. Banking book instruments are generally not measured at fair value through P&L and therefore hedge accounting mechanism is necessary to show offsetting effects between hedged risks and hedging instruments.

Risk management in the banking book is based on hedging the risks in the banking book by entering into *internal* hedging instruments with the trading book. They take a form of derivatives. Trading book aggregates risk positions from all of its external and internal deals and manages trading risks within risk limits. Actions of the trading book are independent of the individual internal transactions with the banking book.

Hedge accounting principles require that only external transactions may be used as hedging instruments. Normally only the trading book enters into external transactions which may be used as hedging instruments for hedge accounting. Because of independent action in the trading book we can hardly find individual external transactions which fully match the internal hedging instruments. In other words trading does not go externally with the internal transactions. However there is a high volume of trading book external instruments and usually suitable hedging instruments similar to the internal hedging instruments and the hedged risks can be found in order to establish hedge accounting.

Risk management objective and strategy are primarily based on the relationship between the hedged risk and the internal hedging instrument. The need of designating external hedging instrument automatically deviates the hedge accounting from the actual risk management. The adverse effects are following:

- hedging instruments have to be searched in an artificial way, which may result in a need to enter into hedging instruments in a way which is costly,
- testing of hedge effectiveness has to be performed between the hedged risk and external hedging instrument which may differ from the actual risk management strategy applied between the hedged risk and internal derivative,
- need of rebalancing may occur even when hedging relationship is unbiased from actual risk management point of view (issue is addressed in the answer to the question 7(a)).

When linking the objective of hedge accounting to the risk management activities IASB should address such issues. Regarding this we do not agree with the statement in the paragraph BC 43 saying that 'The Board noted that the eligibility of internal derivatives as hedging instruments is not the root cause of misalignment between risk management and hedge accounting. Instead, the challenge is how to make hedge accounting operational for group of items and net positions'. As written above the misalignment between hedge accounting and risk management is a serious practical issue which should be addressed properly.

We understand that it is difficult to allow using internal hedging instruments in the current environment when consolidation principles in IAS 27 require that all internal transactions are eliminated. We think that attention to this issue should be also dedicated from conceptual point of view within the phase Elements and Recognition of the Conceptual Framework project.

Furthermore we would like to comment on the requirement that only the risk which could affect profit or loss may be hedged. The revision of IAS 1 a few years ago introduced a concept of total comprehensive income. Other comprehensive income (OCI) components fulfil the definition of income and expenses in the Framework. Therefore the investments in equity instruments designated as at fair value through OCI (FVTOCI) create similar exposure to income volatility as the other items which could affects profit or loss.

Prohibition of recycling for investment in equity instruments designated at FVTOCI attracts much criticism. Now the entities using this measurement category should be further punished because they cannot hedge their economic exposure. Prohibition of hedge accounting for these financial assets is an introduction of a tainting rule which is not substantiated from conceptual point of view. We admit practical concerns of IASB mentioned in the paragraphs BC22 – 26. But they only show that prohibition of recycling for financial instruments is a rule-based measure which creates additional issues.

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?

Yes, we agree with limiting the eligibility of hedging instruments to derivatives and other financial assets and liabilities which are measured through profit or loss. However IASB should address how designation of financial instruments at fair value through profit or loss due to removing of accounting mismatches would be in line with using such instruments also for hedge accounting.

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?

Yes, hedge accounting principles which are focused on risk management activities of the entities should recognise the fact that synthetic exposures comprising derivatives are eligible hedged items. Therefore we welcome the proposal.

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 that risk components are available as hedged items both for financial instruments and for non-financial items.

We have two concerns about risk components which are relevant for our business but the exposure draft does not provide satisfactory solution. We discuss the credit risk component in the answer to the question 15. The issues of LIBOR minus component are not questioned separately in the ED even when this is a major topic which has been raised constantly by the banking industry over past years. For our comments on this issue please see a separate point included in the comment letter after the answers to the official questions.

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?

(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?

(a) We fully support designating a layer component of the nominal amount of hedged items. This is fully in line with risk management strategies which focus on the bottom or top portions of the hedged risk inherent in the hedged items. In such case designating the percentage component of the nominal amount is not a suitable way of designation as very well reasoned in the basis for conclusions.

(b) We do not consider the reasoning in IN22 and BC 69 prohibiting the layer approach for instruments with prepayment options as well substantiated.

"The Board also decided that a layer component of a contract that includes a prepayment option is not eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk. The Board noted that if the prepayment option's fair value changed in response to the hedged risk a layer approach would be tantamount to identifying a risk component that was not separately identifiable (because the change in the value of the prepayment option owing to the hedged risk would not be part of how hedge effectiveness would be measured)."

We do not agree with the restriction concerning the prepayment options because it limits some hedging strategies which are reasonable from risk management point of view.

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An example when bottom layer approach may be relevant for prepayable loans is a group of granted loans for which a bank decides to change interest rate profile of fixed rate loans into variable and indentifies a stable portion which, by experience, is not affected by prepayments. In such case it is irrelevant that fair value changes related to the hedged interest risk are affected also by prepayment option which is not part of the designated hedge relationship. Bottom layer loans are generally not affected by these prepayment options and are held until they mature in accordance with original payment schedule. Therefore optional risk is not relevant for fair value of such loans when looking at them only as a *layer of gross amount of assets*.

We believe that when making this decision IASB was more concerned about the fact that bottom layer approach might be used to replicate the hedges of net positions. In such case the fact that the loans are prepayable would matter.

Two agenda papers from August IASB meetings discussing layer approach mention that the exclusion of prepayable items was introduced deliberately because fair value interest rate hedges of fixed rate loans with prepayment options need special consideration which will be addressed in a separate paper. These issues are discussed in the agenda papers 10-10D from the 16 November IASB meeting which are part of macro hedges phase of the hedge accounting project. The papers started a promising development which would allow bottom layer approach for prepayable instruments. We fully support such efforts because they would bring hedge accounting nearer to the actual portfolio management of interest rate risk.

We believe that it would be much more understandable to explain the exclusion of prepayable items from the layer approach as a temporary solution until these issues will be addressed in the separate phase of the project. We are aware that the area of hedging prepayable items has been a controversial topic over many years. We hope that these prepayment option issues are favourably resolved in the context of macro hedges and then the current exclusion should be redeliberated also for the closed portfolio hedges. However if the macro hedges project will not bring outcome soon (say until the end of 2011) IASB should reopen this issue and solve it at the level of the hedges within the scope of this ED.

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?

Yes, we agree that hedge effectiveness requirements are a qualifying criterion for hedge accounting. We welcome removal of retrospective effectiveness testing and that requirements for assessing the hedge effectiveness are more risk management oriented.

However for financial entities which use internal derivatives to hedge the risks there will still be a difference between actual risk management practices and testing the hedge effectiveness for the hedge accounting purposes. We refer to these issues also in the answer to the question 1 and 7(a).

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?

The concept of rebalancing is new and rather complex as it is explained on 6 pages which are difficult to read. We encourage IASB to include illustrative examples in order to explain rebalancing clearer. Otherwise the requirements may be misinterpreted in the practice. IASB should not be afraid of adding the examples. If they are written in an appropriate manner they do not bring new rules just help in understanding the requirements.

(a) We agree with the requirement that when hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity is required to rebalance the hedging relationship.

However we have a comment concerning the discontinuation of hedge accounting upon rebalancing. As written in the answer to the question 1 a bank hedging the risks enters into internal hedging instruments. To establish an official hedge accounting the bank has to look for available external hedging instruments. If no external instruments are available to meet the qualifying criteria and bank does not want to enter into new external hedging instruments (due to cost reasons) then the hedge is just not established.

If entity has to rebalance the hedge and it has to find a new hedging instrument to create unbiased relationship three scenarios would be relevant:

1. Entity finds a new hedging instrument in the portfolio of existing external derivatives.
2. Entity does not find the necessary hedging instrument within existing external derivatives and enters into new external hedging instrument.
3. Entity does not find the necessary hedging instrument within existing external derivatives but does not want to enter into new external transaction because external transactions may be costly. In such case *discontinuation* of the hedge accounting should be required.

Currently the paragraph 24 of the ED orders that a hedge is discontinued when the hedging relationship ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship). Paragraph B64 further explains in the part (a) that this would happen when hedging relationship no longer meets the risk management objective and strategy on the basis of which it qualified for hedge accounting (ie the entity no longer pursues that risk management objective and strategy). Two other examples given in B64 (b), (c) are not relevant for discussing this issue.

The question is whether not adjusting the hedging relationship is a change in risk management objective and strategy. Actual risk management strategy of a bank, as written above, is based on the relationship between the hedged risk and the internal derivative. Here the rebalancing may indeed be performed for the internal derivatives. Or there may be no need to rebalance the hedge internally. Therefore the actual risk management strategy would not change.

On the other hand if the new external hedging instrument is not added when it is necessary for the rebalancing it will lead to a biased result when we assess the effectiveness as a relationship between the external hedging instrument and the hedged risk. We would end up in a paradox situation when the objective of hedge effectiveness assessment has changed (based on the biased relationship between the external derivative and the hedged risk) even if the actual risk management objective and strategy remains unchanged (based on the relationship between the internal derivative and the hedged risk which is unbiased).

To avoid such confusion in risk management objective and strategy assessments we propose that not adjusting the hedge relationship when rebalancing is required will result in an automatic discontinuation of the hedge. This should be written explicitly in the paragraph B64. We would not like that the hedge accounting requirements are interpreted in such a way that they would lead to forced entering into new external transactions because rebalancing is necessary in a situation when the actual (underlying) risk management policy does not change.

Regarding the question (b) we agree with proactive rebalancing based on expectations that the hedge ratio might change. If a risk management strategy is forward looking and can capture changes in the trends of the variables involved in the hedge relationship entity should have a possibility to reflect this in hedge accounting.

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?

(a) Yes, we agree with the conclusion to discontinue hedge accounting when it ceases to meet the qualifying criteria.

(b) Yes, entity should not be able to discontinue hedge accounting as long as the risk management objective and strategy remains unchanged. However in the answer to the question 7(a) we refer to the differences between the actual risk management objective and strategy and testing the hedge effectiveness at the level of external hedging instrument and the hedged risk. We also propose that not adjusting the hedge relationship when rebalancing is required results in an automatic discontinuation of the hedge. This would happen regardless of what happens to the actual (internal) risk management strategy.

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?

(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?

(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?

(a) We do not agree with the requirement that gains or losses on the hedging instrument and the hedged item should be recognised in OCI. We do not think that double entries of a specific accounting technique should be shown directly on the face of primary statements. What should be recognised is only the final effect of the booking entries – fair value of the hedging instrument, cumulative revaluation of the hedged item related to the hedged risk in the balance sheet and ineffectiveness in the P&L.

As proposed in the ED the OCI entries do not have any final impact for the statement of comprehensive income as regards the total OCI. Therefore the steps leading to this null result should not be shown either. If users want to see the fair value hedge accounting booking entries they can be provided in the notes.

Moreover it is not clear from the exposure draft how such OCI presentation should really work. The ED mentions 3 OCI items:

(a) the gain or loss from remeasuring the hedging instrument,
(b) the hedging gain or loss on the hedged item,
(c) the ineffective portion transferred from OCI to P&L.

However there is no proposal for amendment of IAS 1.7 where the components of OCI are listed.

In such circumstances fair value hedge booking entries might be formally done through OCI accounts but

(i) without presenting them in the statement of comprehensive income.

Or for example if the effect of the item (a) is +10, item (b) -9 and item (c) -1 entities might present in the OCI part of the statement of comprehensive income

(ii) +1 as some “revaluation of fair value hedges” and
-1 as a “ineffectiveness reserve from fair value hedges”
or

(iii) +10 “revaluation of the hedging instrument”
-9 “revaluation of the hedged item”
-1 “ineffectiveness of fair value hedges”
Alternative (iii) was probably the IASB’s intention.

Such free choice would exist as long as the components of OCI are not defined in IAS 1.7.

If IASB keeps the OCI presentation, with which we do not agree, it should amend the IAS 1 accordingly.

(b) We agree with the proposal 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. However we do not agree that the separate line item would be presented next to each line item that contains the hedged asset or liability. Banks hedge large part of their balance sheets and this would extend the number of balance sheet line items significantly. And the reason for this would be more or less technical. Such balance sheet line items cannot be compared with classical line items with a major economic content for understanding the financial position of an entity.

Therefore we propose that there is only one line item on the side of assets and one on the side of liabilities. These two line items would be presented within assets for all hedged items which are assets and within liabilities for all hedged items which are liabilities. Therefore they may have negative values if the cumulative remeasurement of the hedged items is negative. These line items should be broken down and linked to the balance sheet line items in the notes.

The reason for existence of these two line items would also be more technical (as we mention and criticise above). But we support their presentation in order to keep the system of measuring and presenting the financial instruments either at pure amortised cost or at pure fair value.

(c) Linked presentation is not relevant for our bank. However we do not know the magnitude of problems which the gross presentation causes for the specific industry. Therefore we abstain from further commenting on this issue.

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?

(a), (b) We welcome the proposal which enables options to be used as hedging instruments in their entirety. We also agree with the different treatment of time value of the options depending on whether the hedged item is transaction related or time portion related.

(c) Generally we agree with the notion of 'aligned time value' in the paragraph B68 and the 'lower of test' required by the paragraph B69. However application of this requirement is operationally difficult. Therefore we propose that aligned time value has to be determined only if there is not a close relationship between the terms of the hedging option and the hedged item. As a result determination of the aligned time value and the lower of test would be required only for hedges for which a quantitative hedge effectiveness test is necessary at the hedge inception. Put in other words, the aligned time value and the lower of test would not be required for hedges for which a qualitative testing of hedge effectiveness is sufficient at the hedge inception.

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 appreciate that eligibility conditions for group of hedged items were simplified. The new regulation in the paragraph 34 (a), (b) is sufficient for us to apply the *cash flow* hedge strategies at the level of group of items. We do not consider the restriction in the paragraph 34(c) (offsetting cash flows in the group of hedged items must affect profit or loss in the same reporting period) as relevant for our business therefore we do not express our opinion here.

However we would like to emphasise that the proposal prohibiting the layer approach for the groups of hedged items with prepayment options effectively prevents us from applying *fair value* hedge accounting for some of our group hedges. We refer to this issue in the answer to the question 5(b). Only when seeing the proposal for macro hedge accounting we can provide a more comprehensive answer concerning the group fair value hedges.

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?

Yes, we agree with the proposal.

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?

Generally we agree with the disclosure requirements and do not propose any other disclosures.

However the disclosure requirements in the paragraph 52 are unclear for us. There are several points which we would like to comment on.

The required reconciliation is to be provided either *in the statement of changes in equity* or in the notes. We are surprised to see that such highly technical reconciliation may be shown on the face of the statement of changes in equity. Underlying principle for the IAS 1 revision done several years ago was to separate owner and non-owner changes in equity. In paragraph IAS1.IN13 it is written that ‘An entity is not permitted to present components of comprehensive income (ie non-owner changes in equity) in the statement of changes in equity’. All OCI entries are non-owner changes in equity and therefore have nothing to do with the statement of changes in equity.[1]

Furthermore the footnote (a) in the first table of IE 3 says that ‘The information disclosed in the statement of changes in equity (cash flow hedge reserve) should have the same level of detail as the proposed disclosures requirements’. This seems to be a direct reference to the level of detail of OCI disclosures which have to be shown on the face of the statement of changes in equity. Such order would be applicable even if paragraph 52 disclosures were provided in the notes. We cannot understand it in the light of the principle mentioned above.

ED paragraph IE 3 shows how paragraph 52 may be applied. It refers to a tabular format which is relevant for these disclosures. However the tabular format is not mentioned anywhere in the paragraph 52. It is the paragraph 51 which refers to the tabular format of disclosures.

We expect that reconciliation of accumulated OCI required by paragraph 52 should show both opening and closing balances of the OCI items (e.g. cash flow hedge reserve). However, the illustrative example IE 3 does not show any opening and closing balances.

As a solution we propose that these disclosure requirements have to be provided only in the notes. Requirements of paragraph 52 should be better aligned with paragraph 51 and should also require a tabular format. For a better understanding of the links illustrative example part should cover all the requirements which are currently in the paragraphs 51 and 52.

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?

Even when this proposal does not concern our business we consider it as a very reasonable.

[1] On the other hand also the current IAS 1 (after considering the May 2010 annual improvements amendment) is not in line with this principle because IAS1.106 requires that items of profit or loss and other comprehensive income which constitute non-owner changes in equity are presented separately. Then the paragraph 106A further denies this principle when it allows that analysis of *each item* of OCI may be provided directly in the statement of changes in equity.

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 welcome that IASB addresses the issue of hedging the credit risk in its discussions. However we do not consider as a good idea to start the discussion in the basis of conclusions by saying that credit default swaps (CDS) are not suitable hedging instruments for hedging the credit risk.

We admit that there is a rationale in the argumentation found in the paragraphs BC221, 222 that credit default prices might not be suitable for measuring the credit risk component of a financial instrument. This is true if we are focused on getting the best possible theoretical value of the credit risk. But such determination is complex if not impossible. In the risk management practice CDSs are used as the best instrument which is available to hedge the credit risk. Such risk management practice is recognised also by IASB in the basis of conclusions. Markets with CDSs are liquid and provide a transparent way of measuring the credit risk.

Furthermore not allowing credit default swaps to be used in a hedge accounting of credit risk is in contradiction to the fact that ED is focused on actual risk management practices and also allows designation of a risk component as being hedged. It is allowed to hedge even non-contractual risk components. In paragraph B16 we can find an example that jet fuel purchases may be hedged on the basis of crude oil price component. We agree with this. But then we do not see a reason why we should not find such a clear economic relationship between the credit risk of a financial asset and a CDS.

Such hedging relationship would be designated in relation to the credit default swap spread component rather than just the credit risk component which indeed may not be reliably measurable.

If hedges of credit risk by using credit default swaps are not allowed then we ask how component fair value option should work instead. Such component would face the same issues of measurement reliability. Therefore we propose to withdraw the paragraphs in the basis of conclusion discussing the hedges of credit risk using credit derivatives. This would permit using the credit default swaps as hedging instrument by using a standard hedge accounting mechanism. IASB may additionally introduce some restricting criteria for such hedges. Such criteria however should not end up with rules which restrict hedge accounting of a credit risk to a minimum. A reasonable requirement may be that there is a substantive economic relationship between the credit risk of the hedged item and the credit default swap.

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 with the proposal to apply the new hedge accounting requirements prospectively. The proposed effectiveness date 1 January 2013 is unrealistic considering all major IFRS changes which entities face currently and in the years to come. But we are aware of the fact that the proposed date will be subject to a revision based on the comments received on a separate IASB initiative.

Sub-LIBOR issue

We understand the arguments of IASB in BC70-BC74 and in related staff papers that designation of Libor components for liabilities with sub-Libor rate may lead to a counterintuitive result. This is due to the fact that the floor element may produce additional negative cash flows if Libor falls below the absolute value of the negative margin. Put in other words if, for example, the variable rate deposits have negative margin -1.50% below Euribor[2] then using plain vanilla interest rate swaps as hedging instruments would not fix the cash outflows from deposits in all cases but would produce additional cash outflows provided Euribor falls below 1.50%.

However we believe that this optional element (floor) is not something which should prohibit hedge accounting but should rather result in recognition of ineffectiveness. If a risk management strategy is to hedge the variable rate liabilities with negative margin to Euribor (e.g. -1.50) by using interest rate swaps and to bear further negative cash flows in case Euribor is below the absolute value of the margin (i.e. 1.50%) such strategy should be permitted for hedge accounting. Euribor falling below the margin should not lead to hedge rebalancing if the risk management strategy is not to hedge such negative residual component but rather bear the negative consequences. Indeed such hedging strategies are applied in the practice.

However, the negative cash flows which the entity faces when using such hedge constructions should be fully recognised as an ineffectiveness in profit or loss. Such ineffectiveness *would not be* taken for hedge effectiveness testing purposes and *would not* lead to a termination of the hedge or rebalancing if it is in line with risk management strategy. The ineffectiveness *would be* recognised when determining the booking entries. It means revaluation of the hedged item should reflect the losses which the entity faces. Intrinsic value of the floor may be a faithful representation of such losses.

For illustration of the proposal we use an example for cash flow hedge of deposits with negative margin 1.50% below Euribor. When calculating the present value of the change in the hedged cash flows as required in paragraph 29(a),(ii) the cash flows should include also

[2] Sub-Libor is a general term referring to the cases when variable rates are linked to referrence rates. In our case the most common referrence rate is Euribor therefore we further use this term in our comment letter.

the intrinsic value of the floor with a strike rate 1.50%. Comparing cumulative gains / losses on the hedging instrument with the hedged cash flows replicated by a combination of a hypothetical swap and the intrinsic value of the floor option would lead to the recognition of the ineffectiveness in P&L. This ineffectiveness (loss) matches the losses which the entity faces when Euribor is below 1.50%.

Time portions of hedging instruments

Paragraph 8 of the ED says: *"However, hedging instrument cannot be designated for only a portion of the time period during which a hedging instrument remains outstanding"*. This rule has been transferred from IAS 39.75. This sentence is not easy to understand and more interpretations can be encountered in the practice. Our bank faces a very strict interpretation saying that the maturity of the hedging instrument cannot be longer than the maturity of the hedged item. This prohibits some hedging strategies which we apply from qualifying for hedge accounting and creates a serious issue for us. This was probably not the aim of IASB.

When interpreting this rule some guidance could be found in the BC and IG of IAS 39. However the ED does not discuss this rule at all in any part of it. Therefore the need for clarification is even more important in the future standard. We are of opinion that the rule should be reformulated or further clarification should be provided. The new wording should prohibit designating the time portions of hedging instruments that would cause that only part of the hedging instrument (fair) value gains/losses enter into the hedge during the hedging period. To be more specific on our proposal:

- the requirements should disqualify following cases from designation for hedge accounting
  - using *7-year* fair value changes of 10-year swap for hedging 7-year interest risk,
  - using foreign exchange differences on specific cash flows of a non-derivative financial instruments in foreign currency (e.g. payments in the year 3 of a 10-year liability) as an hedging instrument for hedging the FX risk (e.g. revenues in foreign currency received in the year 3),

- following hedging relationships should be available for hedge accounting
  - using fair value changes of 10-year swap in *their entirety* for hedging 7-year interest risk (when choosing proper hedge ratio such hedge relationship can work very effectively during some period, after this period it would have to be rebalanced),
  - using 60% of fair value changes of 10-year swap in *their entirety* for hedging 7-year interest risk (i.e. percentage of the nominal amount of the above case),
  - using foreign exchange differences on non-derivative financial instrument *in their entirety* during some period of maturity of the instrument (e.g. FX gains/losses on 10-year liability arising during the first 3 years of maturity to hedge revenues in foreign currency received in the year 3),
  - using foreign exchange differences arising on 60% of the nominal of non-derivative financial instrument during some period of maturity of the instrument (i.e. percentage of the nominal amount of the above case).

Cash flow hedges – present value of the change in the hedged cash flows

We welcome the clarification in the paragraph 29(a),(ii) saying that hedged item in a cash flow hedge should be assessed based on 'the present value of the change in the hedged expected future cash flows'. This replaces the IAS 39 requirement in IAS 39.96(a),(ii) referring to 'the cumulative change in fair value (present value) of the expected future cash flows on the hedged item…' which does not work when taken literally. For example for hedges of variable rates cumulative change in the present value of future variable interest payments (calculated based on forward rates) will be never equal to the cumulative gains or losses on hedging swap as it should be when the critical terms of the hedging instruments and hedged items are the same. Now the paragraph 29 (a),(ii) brings much improvement compared to the IAS 39.

However the ED paragraph 29(a),(ii) still uses the old IAS 39 wording 'the cumulative change in fair value (present value) of the hedged item…' in the first part of the sentence which is rather misleading. Then the correct principle 'the present value of the change in the hedged expected future cash flows' comes only in the bracket. Therefore it should be considered whether only the part currently in the bracket should not be used in this paragraph. Or the paragraph may start only with some general words containing the term 'cumulative' to match the paragraph 29 (a),(i), e.g. 'cumulative change of the hedged cash flows', and then the correct specification would follow.

We would also like to comment on another issue connected with this area. Calculating the changes of the expected cash flows on the hedged item *on present value basis* is not substantiated for hedging the spot rate risk in foreign currency hedges. When hedging the spot FX risk of forecast transactions the *present value* of the change in the hedged cash flows does not match the spot revaluation of the hedging instrument.

Especially when using *non-financial hedging instruments,* calculation of the present value on the hedged cash flows side would lead to a rather artificial result. For example when the FX rate has changed from 1.0 to 1.25 from inception of the hedge and the hedged cash flows have nominal amount 1 000 000 the change in the hedged cash flows is 200 000 (= 1 000 000 / 1.0 – 1 000 000 /1.25). The same amount can be found on the side of non-financial hedging instrument when calculating the FX differences under IAS 21. However if we discounted the change 200 000 on the hedged item side to present value (rate 5%, 1 year remaining till the end of the hedge) the result would be 190 476 (= 200 000 / 1.05). It would never match the FX gain/loss on the hedging instrument side because it is calculated only on the basis of changes in the spot rates (undiscounted). Should in such case only 190 476 be transferred into OCI (cash flow hedge reserve) and residual 9 524 would remain in ineffectiveness P&L? This would be illogical because we have established 100% effective hedge. Sticking to the present value would always result in overhedges with some of the hedging instrument FX gains and losses recognised as ineffectiveness. The reason is that present value on the hedged cash flow side is always lower than the undiscounted FX gains and losses on the non-derivative hedging instrument side.

FX revaluation of the non-derivative hedging instruments reflects the cumulative changes in the spot rates. It should be matched to the hedged cash flows which also reflect the spot rates changes and are not discounted. These spot rate changes are recorded for the period that has passed. Including the discounting over the remaining hedge period introduces artificial elements in such hedges.

If we admit that it is not reasonable to calculate the changes in the hedged cash flows for foreign currency risk hedges on present value basis then it may be worth to expand this for hedges of FX risk regardless of whether non-derivative or derivative hedging instruments are used. When using a derivative as a hedging instrument (FX forward) the entity is allowed to designate only the spot price fair value changes as a hedging instrument. If the hedged item was measured on undiscounted basis then also separation of such spot element of FX forward would be more straightforward. If we take the figure from the example above the spot price changes of the forward would reflect the hedged amount of spot risk 200 000 and not the more complicated present value 190 476.

Our proposal is that if spot FX risk is hedged then the changes in the hedged expected future cash flows should not be calculated on present value basis. This is relevant at least when non-derivative hedging instruments are used but we think that this notion is reasonable regardless of type of hedging instrument.

It may be also worth to consider whether this is also not relevant for hedges of any other spot price risk (equity, share) for which an entity can separate and designate the spot price element of the hedging forwards.

If you have any questions regarding our comments do not hesitate to contact us.

Yours sincerely,

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