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Comments to the EFRAG's draft comment letter on the IASB's Exposure Draft ED/2010/13 Hedge Accounting

Dear Ms. Flores,

we would like to send our contribution to the EFRAG's draft comment letter. On February 23 Erste Group sent its comment letter also to IASB. We attach this comment letter because in our answers to EFRAG we often refer to it.

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We have put all our comments and references in the answers to the questions raised by EFRAG. However one topic which is very important for us remained unplaced. We kindly ask EFRAG to take it into consideration in the final comment letter as well. In our comment letter sent to IASB you can find it on the page 15 under the heading 'Time portions of hedging instruments'.

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 with the opinion of EFRAG written in the paragraphs 4-7. We refer to our comment letter sent to IASB where we specifically address the issue of not allowing the hedges for investments in equity instruments which are designated at fair value through OCI. We also point to the fact that not allowing using of internal derivatives for hedge accounting

introduces rather artificial elements when linking the objective of hedge accounting to actual risk management activities.

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 believe that the proposal of EFRAG in paragraph 15 (to consider extension of the range of eligible hedging instruments to equity instrument through OCI, instruments at amortised cost, components of non-derivative hedging instrument other than FX risk) brings interesting ideas. However due to their revolutionary character they are not realistic to be introduced in the forthcoming standard due to time constraints. They are worth to be discussed in a longer-term conceptual debate on hedge accounting which may be initiated and pushed forward by the EU as a major IASB stakeholder.

In our comment letter sent to IASB we also ask for clarification how fair value option designation for financial instruments removing accounting mismatches is in line with using them also as hedging instruments for hedge accounting.

Question to constituents

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?

IASB considers hedge accounting and fair value options as two different areas of accounting for financial instruments. We believe that even when there is inconsistency there is no use in addressing such fair value option issues as IASB will be reluctant to reopen the fair value option discussion.

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 EFRAG's comments provided in the paragraphs 21 and 22.

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 with the EFRAG's comment in the paragraph 30.

Questions to constituents

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

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.

Regarding prohibition of hedging the non-contractual inflation components we have not identified this as an issue in our bank. However if other constituents view this differently we agree that EFRAG gives the dissenting option here.

Regarding hedging the sub-LIBOR components we refer to our opinion in a separate part of our comment letter sent to IASB on the pages 13 and 14. We do not agree that such hedges are not allowed and propose a way of tracking ineffectiveness of such hedges.

EFRAG addresses the issues of hedging the sub-LIBOR components also in the supplement to the draft comment letter. We include the questions raised by EFRAG in this part of our comments.

Questions to constituents

Do constituents believe that hedging occurs frequently, in practice in situations similar to the one described in examples 1 and 2, above? If so, could you please explain the underlying fact pattern?

Do constituents have any other concerns regarding the requirement in the Exposure Draft in this respect?

In our case instruments with sub-LIBOR components are indentified with deposits. Generally their rates are linked (non-contractually) to interbank reference rates. Rates of such deposits are generally fixed until the maturity of deposits. As new deposits come and the old mature the portfolio of deposits behaves like variable rate over the time. Application of cash flow hedges for such deposits is relevant in our case.

For the second question please see our answer above.

Questions to constituents

Could constituents please provide examples of financial assets without a floor (i.e. the holder of the financial asset might need to pay interest to the issuer)?

Do constituents believe that a financial asset that is indexed to a benchmark with a negative offset (e.g. US Prime minus 0.3%) would qualify for measurement at amortised cost under IFRS 9? If so, why?

Do constituents believe that a form of hedge accounting should also be permitted in the example above? If so, how would that hedge accounting work?

We do not have financial assets without a floor in our portfolio.

We believe that such instruments would have to be fair valued under IFRS 9. The reason is that the investor is not able to prove that interest is a consideration for the time value of the money because the interest may be negative.

Hedge accounting should be allowed for such instruments because by using interest rate swaps an entity can fully lock the margin.

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?

In accordance with our comment letter sent to IASB we agree with the EFRAG's answer in the paragraph 41.

Question to constituents

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.

We do not agree with the prohibition of designating a layer component of a contract that includes a prepayment option as a hedged item in a fair value hedge. We understand that when introducing this rule IASB was afraid that these issues have not been properly discussed at macro hedges level. Therefore we can accept the prohibition only as a short-

term temporary solution. This prohibition should be removed as soon as a solution for macro hedges comes. If no such solution comes soon this part of the hedge accounting should be redeliberated. For a detailed reasoning please see our comment letter sent to IASB.

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 with the EFRAG's comments in the paragraphs 51-54. We welcome that EFRAG addresses the issues of inconsistencies between internal risk management and testing the hedge effectiveness for the hedge accounting purposes. Maybe this should be emphasised even more in the comment letter. We refer to these issues also in the answer to the question 1 and 7(a) in our comment letter sent to IASB.

Concerning the point (b) in the paragraph 54 we have identified a similar issue that artificial temporary ineffectiveness may arise when hedging spot FX risk by using non-derivative financial instruments. We analyse this issue in the final part of the comment letter sent to IASB named 'Cash flow hedges – present value of the change in the hedged cash flows'. (Please note that we also discuss the wording of the ED paragraph 29(a),(ii) in this part.)

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 with the comments of EFRAG in the paragraphs 68-72. However we doubt that there is sufficient time for field testing of operationality of such proposals. The idea of field testing is good. But if EFRAG keeps it in its comment letter it should also discuss how such testing is in line with the tight time frame for finalising the standard. Should it be undertaken after the standard is published? (There will probably be still much time before the standard becomes effective.)

In our comment letter sent to IASB we also call for including examples for rebalancing because the requirements are difficult to understand. Furthermore we describe our proposal that if entity does not rebalance the hedging relationship when it is necessary this should lead to automatic discontinuation of hedge accounting regardless of what is happening in the internal risk management. This comment again refers to the differences between hedge accounting and actual risk management.

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?

We agree with the EFRAG's comments in the paragraphs 76-78.

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?

We agree with the EFRAG's comments in the paragraphs 89-92,94. Please see our comment letter sent to IASB for the argumentation why OCI is not a good way to present fair value hedges. In case IASB does not accept argument against OCI we are furthermore concerned that these OCI items are not defined directly in IAS 1 and this would lead to confusions.

Regarding presentation of gain or loss on the hedged item attributable to the hedged risk our proposal is to have one balance sheet item on the side of assets and one on the side of liabilities. Therefore our opinion is slightly different from the EFRAG's proposal (in the paragraph 93) to aggregate all the gains and losses only in a single net amount. However our opinions are the same as regards opposing the IASB proposal to present one line item for each balance sheet position which is hedged.

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?

In our comment letter sent to IASB we do not oppose to the IASB proposal to distinguish between transaction related and period related hedges. The reason for this is that in our bank only period related hedges will be probably relevant. But we are not against EFRAG's proposal to have a single approach. Therefore we agree with the comments of EFRAG in the paragraphs 103-105.

In the EFRAG's draft comment letter there is no answer regarding the question 10(c). We refer to our answer to this question in our comment letter sent to IASB. There we agree with the notion of 'aligned time value' and the 'lower of test' for hedges using options as hedging instruments. However due to operational complexity we propose to apply it only in the cases when there is not a close relationship between the terms of the hedging option and the hedged item (i.e. when quantitative testing of hedge effectiveness is required 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?

Because the EFRAG's comments are not very specific we refer to the answer in our comment letter sent to IASB.

We agree with the EFRAG's comment that it is difficult to find the underlying principle for the group hedges.

Furthermore in the answer to this question we would like to point to unclarities in defining the scope of the ED. The scope is limited to micro hedges (where changes in hedged items and hedging instruments are allowed only by de-designating and redesignating the hedges) whereas some parts of the ED permit some type of hedges with dynamic aspects. We describe this issue more in the opening part of our comment letter sent to IASB.

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 agree with the EFRAG's comments in the paragraphs 122-124.

As regards presentation of the cumulative gains/losses on the hedged item in fair value hedges in the balance sheet we present opinion which is slightly different to EFRAG (see the answer to the question 9). However for the hedges of net position we agree with the net presentation which would be applied at the level of a particular net position hedge. Cumulative change in the fair value of the hedged risk should be derived from the net position and should be presented within assets if the net position is asset (together with revaluations of other hedged assets) or within liabilities if the net position is liability (together with revaluations of other hedged liabilities). Put in other words, in conformity to the EFRAG's opinion we do not agree with the presentation of net position hedges on a gross basis in the balance sheet.

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 agree with the comments of EFRAG in the paragraphs 128-131. Furthermore we refer to unclarity of disclosure requirements in the paragraph 52 and the links with paragraph 51. Please see our comment letter sent to IASB for a detailed analysis of this issue.

Question to constituents

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

We believe that this question is more oriented to the users of financial statements who may provide more valuable input here. Our opinion from preparer point of view is that the proposed disclosures meet the objective of providing transparency. Transparency would be further increased when the comments are accepted.

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 agree with the opinion of EFRAG expressed in the paragraphs 139, 140.

Question to constituents

Do you believe the proposals will be useful in addressing problems in practice ? If not please explain.

From its initial consultation activities, EFRAG has understood that this 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)

As these issues are not very much relevant for our business we abstain from commenting on these questions.

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?

The arguments of EFRAG given in the paragraphs 157-160 are written in a rather general way. We appreciate that they are in favour of allowing the hedge accounting of credit risk by using CDS. This is also the way how we want to solve this issue. Our comment letter sent to IASB brings more specific argumentation and we refer to it. The main notion is that 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.

Question to constituents

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?

We are not in favour of any of the three proposed alternatives as we believe that this issue should be solved within a proper hedge accounting mechanism. Please see also our comments written in the position sent to IASB.

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 EFRAG's comment in the paragraphs 164-168.

If you have any questions regarding our comments do not hesitate to contact me or Martin Svitek (martin.svitek@erstegroup.com, +43 50100 13135, +43 50100 6 13135).

Yours sincerely,

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