European Banking Federation

Secretary General

FS/MT
EBF Ref. N° 0090

**E-mail**

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Canon Street,
UK – London EC4M 6XH

Brussels, 9 March 2011

***Subject*:** ***EBF response to the IASB Exposure Draft on Hedge Accounting***

Dear Sir David,

The European Banking Federation (EBF)[1] welcomes the opportunity to provide comments on the Exposure Draft on Hedge Accounting.

We enclose herewith our comments and answers to specific questions raised in the Exposure Draft *(see D0421B-2011).*

We hope that you will find our comments useful and are at your full disposal should you wish to further discuss any of our comments.

Yours sincerely,

Guido Ravoet

Enclosure: 1

[1] *Set up in 1960, the European Banking Federation is the voice of the European banking sector (EU & EFTA countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.*

a.i.s.b.l.

10 rue Montoyer B- 1000 Brussels
+32 (0)2 508 37 11 phone
+32 (0)2 511 23 28 fax
http://www.ebf-fbe.eu

European Banking Federation

EBF Ref.: D0421B
Brussels, 9 March 2011

***Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions. The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.***

# EBF COMMENT LETTER ON THE HEDGE ACCOUNTING EXPOSURE DRAFT

## Key Points

The European Banking Federation (EBF) welcomes the opportunity to comment on the Exposure Draft on Hedge Accounting (ED).

We have also appreciated the Board's outreach activities during the development of the ED and would like to encourage the IASB to keep on working in close cooperation with the banking industry during the development of the second phase of the project which will address macro-hedging.

The EBF fully supports the aim of the review of the current hedge accounting principles which is to reflect the entity's risk management activities. However, until the Board has further advanced its deliberations over open portfolios, the EBF does not have sufficient contextual information to fully validate the proposal and its consequences for a future proposal on open portfolios. Indeed many banks operate open portfolio or macro hedging in order to manage their risk, whilst the ED focuses on hedge accounting for single assets and liabilities. The EBF therefore looks forward to the opportunity of making a final assessment of the whole revision of hedge accounting rules, including portfolio hedging.

The ED proposes positive developments including: reference to risk management practice, a simplification of the hedge effectiveness assessment and the elimination of the bright line 80-125, approach by components, revaluation of both sides of the hedge in a fair value hedge, and amendments to the notion of groups of hedged items.

With particular regards to the reference to risk management practice, we strongly assert that the standard must be entirely faithful to the risk management objective. It will necessarily fail in its principle if the Board precludes companies from applying hedge accounting to broadly accepted risk strategies that are used in practice to manage economic exposures. In particular, we are eagerly monitoring the Board's progress in considering:

- Designation of a Libor risk component of financial instruments which may have a negative spread to Libor (the sub-Libor issue).

- Designation of non-financial items and financial items without a predefined maturity according to the models which take into account their behavioral or risk characteristics for the purpose of determining the entity's risk position.

- The non-acknowledgement of internal contracts and prohibition of de-designation when internal contracts are not recognized; should internal derivatives continue to remain "out of scope" in the final standard - it is imperative that an entity have the ability to dedesignate voluntarily. This would be absolutely necessary to achieve reasonable results.

- Abolishment of the exception set by paragraph B 23 to disallow the bottom layer approach for groups of items containing contracts with prepayment options where the option's fair value is affected by changes in the hedged risk.

- The prohibition of hedging credit risk; hedge accounting for credit risk is achievable. The opinion expressed in the BC is rule-based and therefore not in the spirit of a principle-based approach to setting accounting standards. Furthermore, it would prematurely disqualify hedge accounting for credit risk hedging. There are developments in the market to show that credit risk hedging satisfies the 2 qualifying criteria for a risk component.

- Disregarding certain components of the hedging instruments for risk management purposes e.g. insignificant changes in the counterparty credit risk or non-zero fair value ("take-on RV") when the hedge relationship is designated sometime after the derivative has been entered into).

- Designation of equity investments designated at fair value through other comprehensive income.

- Hedging of forecasted earnings ("earnings at risk hedge") rather than hedging fair value of existing assets or liabilities (fair value hedge) or variability in future cash flows (cash flow hedge).

- Multi-currency hedging into a currency other than the functional currency of the entity (please refer to the examples in our responses to Question 3).

- Hedging of basis risk which would require negotiating floater vs floater IRS. Such instruments which are important for a meaningful management of basis mismatch (i.e. Euribor 3m vs Euribor 6m over 5 years) do not seem to be supported by the ED and remain out of scope as for hedge accounting is required.

Given the inter-relationship of these issues with the principles of the ED, we strongly encourage the Board to re-expose the composite standard when it completes its work on phase 2. The EBF looks forward to the opportunity of making a final assessment of the whole revision of hedge accounting rules, including portfolio hedging.

We would also strongly encourage the Board to cover the specific guidance on the macro cash flow hedge model within the body of the future standard, similar to the portfolio fair value hedge of interest rate risk, rather than carrying forward the interpretative guidance in form of examples from IAS 39 IG.F.5 and IAS 39 IG.F.6.

On the whole, the ED makes many positive steps toward a more simplified and principles based framework for hedge accounting. We applaud such positive developments as the simplification of the hedge effectiveness assessment and the elimination of the bright line 80-125 test, the ability to designate risk components of non-financial instruments, the streamlining of the criteria for hedges of a group of items, etc. However, there are concepts that will be operationally impracticable without more clarity *inter alia*:

- The wording within B29 implies that the objective of the hedge effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness. Given that the objective of hedge accounting is to reflect the risk management activities minimizing ineffectiveness does not seem to be an obvious objective. In general hedge ineffectiveness comes not from the risk management but from the basis between the hedged item and the hedging instrument and therefore it is a by-product of hedge accounting not a consideration for hedge designation. This distinction is important because rebalancing and or de-designation seems to be implied for ineffectiveness without allowing tolerances implying rebalancing would be required for accounting where risk management would not require it. Also if strictly applied it could require a tighter hedge than required to meet 'highly effective' under IAS 39.

- Consequences of the designation of net position;

- Consequences of the designation of derivatives as hedged items;

We disagree with the prohibition of voluntary de-designation of a hedging relationship. Risk management strategies (of financial institutions esp.) are inherently dynamic and are influenced by risk-specific as well as strategic business factors. We do not believe that voluntary de-designation creates the risk of earnings management as companies cannot predict the future behavior of risk.

Our detailed comments in this respect are set forth in the appendix, as answers to the specific questions raised in the ED.

# APPENDIX

## Answers to the specific questions raised in the Request for Views

### OBJETIVE OF HEDGE ACCOUNTING

**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?**

Important to note is that in the absence of the Board addressing the above items in the key point section in either the re-deliberations of phase 1 or through phase 2, we question whether and how there can be an adequate link between the risk management strategy of the Bank and hedge accounting.

We do not object to the definition of the objective of hedge accounting, which is very broad and therefore indisputable. Nevertheless, it must be highlighted that various rules newly included in the ED or taken up from rules-based existing IAS 39, like the sub Libor issue, the non acknowledgement of internal contracts, the exception set by paragraph B 23 to the bottom layer approach, to name a few, prohibit in fact using risk management strategy to justify many hedging transactions. These constraints, which de facto could be considered as loopholes in the framework, will lead institutions to renew their current practice of artificially designate hedged items not related to the risk management strategy, only to fulfill accounting requirements. In such circumstances, the corresponding disclosures will necessarily be often meaningless as some source of risk, effectively and actively managed by financial institutions like core deposits, remain ineligible to hedge accounting.

We notice also that the proposed standard prohibits hedging for equity investments designated at fair value trough other comprehensive income. From a risk management perspective, nothing precludes an institution to hedge such investment. So, this accounting prohibition conflicts obviously with the stated objective for hedge accounting. That means that the general objective designated from hedge accounting, to translate adequately in financial statements the risk management strategy of entity is not the basic principle supporting the whole text. BC 23 to BC 26 highlight some technicalities arisen from the decision not to recycle in P& L, the realized value of such investments, but in our view, they are not convincing to justify the de facto prohibition of hedging those securities. Furthermore, as BC 27 pinpoints that a forecast dividend from such investments could be an eligible hedged item, it is illogical to preclude from this status, the sum of the discounted forecast dividend, which is the recorded fair value of these securities.

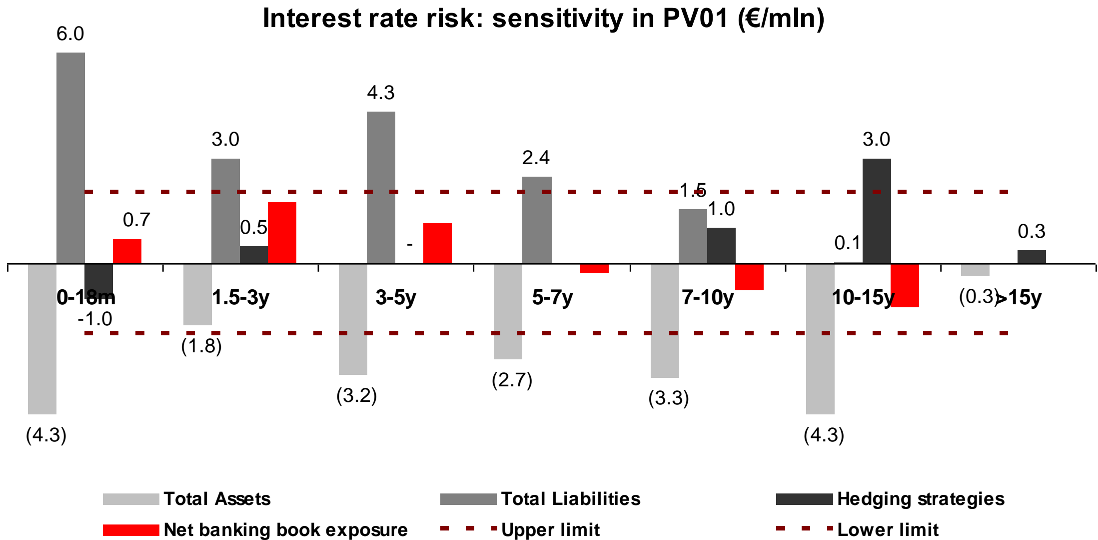
Therefore, we emphasize our concern that the standard must be through-out faithful to its principle. Scoping limitations on risk management strategies themselves (modeling of core-deposits, the sub-libor issue, prepayment features, etc.) will render the risk management objective of the ED entirely ineffective. The result will be that hedge accounting designation would continue to follow hedge accounting requirements rather than the effective risk management practices.

We note that, under Basel III, the risk models of financial institutions are subject to a high level of documentation and testing. Basel III acknowledges the viability of different internal risk management models depending on the size and complexity of the entity's operations and passes on the responsibility for proving the effectiveness of the internal models in achieving the targets and the existence of proper governance processes to financial institutions reviewed by the auditors. We believe that a similar framework could be established as a basis for the application of hedge accounting.

We would like to emphasize that the use of risk management strategies which relates to the banking book typically involves positioning the interest rate sensitivity within limits granted at both an aggregated and time-band (bucket) level. Such limits, which differ amongst organizations, allow a risk mismatch in time buckets, calculated as the total possible profit (delta positive exposure) or loss (delta negative exposure) in a given time bucket if the market rates increase by 1bp (0.01%).

The enclosed graph shows how fixed rate assets and liabilities are measured per se and how the hedging derivatives decrease the overall next exposure (in red) so to be contained within the limits.

Such calculation is 'state of the art' and a very perfect match can only be obtained by an almost endless designation and re-designation of hedging derivatives and adjustment of the hedge.



## INSTRUMENTS THAT QUALIFY FOR DESIGNATION AS HEDGING INSTRUMENTS

**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 support the proposal to use non-derivative financial instruments as hedging instruments. However, we urge the IASB to reconsider its decision to restrict this possibility to non-derivative instruments measured at fair value in their entirety: we see no conceptual basis for excluding financial instruments that are not at fair value through profit and loss as eligible hedging instruments. This echoes our answer to Question 1: hedging should not be limited to P&L-affecting transactions.

Furthermore, the ED is internally inconsistent since it argues that there are no difficulties in identifying non-contractual components that could be designated as the hedged items, while it seems to say that it is impossible to reliably measure non-contractual components in hedging instruments. On balance the IASB ought to come to the conclusion that this cross-cutting issue needs to be explored further, without being restricted by the self-imposed time table.

## DERIVATIVES THAT QUALIFY FOR DESIGNATION AS HEDGED ITEMS

**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 note that an aggregate exposure that is a combination of an interest rate risk exposure and a currency risk exposure, e.g. a synthetic position, mixing cash instruments and derivatives, may be designated as a hedged item. This aggregated exposure will be managed as one exposure for particular risks. Clearly, from a risk management perspective, exposures are managed per se, without taking into consideration the fact that they stem from cash position or derivatives. So, the faculty of mimicking the effective basis of the risk strategy for hedge accounting designation is welcomed.

But, given the significant implications for portfolio hedging of this decision, we believe that clarifications are necessary:

- What are the implications for the derivatives part of the exposure; as they are not hedging instruments, are they trading ones?

- Can such aggregate position be considered only when two risks (interest rate risk and currency risk for example) are managed simultaneously as one global exposure?

- How to account for the risk hedged on both the derivatives (presumably on fair value basis) and the cash instruments (at cost) when only risk arising from a component of the exposure is hedged?

- Additionally, with regard to the qualification for designation as hedged items (paragraphs 12-14), we would like to mention that the final standard should allow to qualify the forecast results of a subsidiary as a hedged item, doing so hedge accounting would be aligned with the entities risk management strategies and volatility in the P&L account due to the translation risk, would be avoided.

We believe that more clarity could be conveyed if the principles of designation as a hedged item of a combination of derivative and non-derivative instruments were demonstrated using examples, e.g.:

- Example 1: a fixed rate foreign currency debt in combination with a receive fixed pay floating interest rate swap is designated as a hedged item in a cash flow hedge of foreign currency risk, where the hedging instrument is a basis cross-currency swap converting variable cash flows in the foreign currency into variable cash flows in the local currency;

- Example 2: a fixed rate foreign currency debt in combination with a receive fixed pay floating interest rate swap is hedged with a basis cross-currency swap converting variable cash flows in the non-core foreign currency into variable cash flows in another foreign currency which is not the functional currency of the entity, but naturally offsets other cash flows in the same foreign currency;

- Example 3: highly probable forecasted variable rate foreign currency cash inflows in combination with highly probable forecasted basis cross-currency swaps converting variable cash flows in the foreign currency into variable cash flows in the local currency are designated as a hedged item in a cash flow hedge of interest rate risk, where the hedging instrument is a receive fixed pay variable interest rate swap in the local currency.

Many entities have subsidiaries in foreign countries whose operations are performed in a functional currency which differs from the parent company's functional currency. Regarding profit and loss, the annual results in local currencies of these entities are translated to the consolidated profit and loss account using the average exchange rate of the period (this is for practical reasons. However, if exchange rates fluctuate significantly the exchange rate of each transaction should be used).

Then, the variability of the exchange rate of the local currency in respect to the functional currency of the parent company, give rise to a foreign exchange risk exposure in the consolidate financial statements, and entities want to hedge this risk, sometimes 2-3 years ahead.

According to paragraph 14, if a hedged item is a forecast transaction, that transaction must be highly probable. From our point of view, a portion of predicted revenues, normally those expected in the short term, will meet the "high probable" criterion. Additionally, 2-3 years forecast results in a retail banking business which is very stable and forecast results are based on historical information, could be also predictable with a high probable criterio. This

hedging relationship will have to meet all the hedge effectiveness requirements according to paragraphs B27-B39.

## DESIGNATION OF RISK COMPONENTS AS HEDGED ITEMS

**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?**

A risk component can be designated as hedged item, as long as it is separately identifiable and reliably measurable. We agree that this aligns more closely hedge accounting with risk management. The determination of appropriate risk components will require an evaluation of relevant facts and circumstances. We however note that a designated component must be less than or equal to the total cash flow of the asset or liability

We note that this rule contradicts the overarching principle of aligning hedge accounting to the risk management practices. It is common within financial institutions to use benchmark rates (e.g. Libor/swap rates) to price assets or liabilities. The spread to the benchmark rate (either positive or negative) may or may not be included in the risk management strategy. We strongly believe that the hedge accounting designation should follow the risk management, so that either the Libor component or the total cash flows of a sub-Libor instrument can be designated, rather than adopting specific rule-based restrictions.

Allowing sub Libor hedges to be designated on a risk components basis is not inconsistent with the instrument being hedged in a true margin hedge of a liability. This will delete an inconsistency in the existing IAS 39 risk component approach for hedging, as asset and liabilities are priced in financial markets in the same ways and accounting hedging requirements are different.

Any hedge can be operated only on a market index; hedging transactions do not cancel any risk when ones consider the whole financial system. It only transfers it from the hedging institution to a third counterpart. To be able to transact, market participants must agree on a general representation of the exchanged risk. This representation is commonly denominated as a benchmark. For interest rate risk, the benchmark accepted by markets participants is the Euribor/ Libor index. Assets are normally priced with a margin over this index, which is revenue for the institution to cover administrative costs, credit risk and capital costs. Liabilities are priced according the same logic, in order to cover exactly the same costs, except for the third party credit risk but including own credit risk, to provide for the same revenue: as the cost of liability is an expense, the margin is “negative” to provide for this revenue. There is no rationale to prohibit this component approach, as the reasoning used to identify the Libor component of an asset- assuming a fixed rate can be decomposed in a Libor plus a spread coupon according to the theory of assets pricing- is equally valid for the components of liabilities prices.

So, we support the component approach, as it is in line with the risk management strategies, but, we think that some more work is needed around the notions of instruments' components and markets' benchmarks when the benchmark is not explicitly part of the contractual pricing formula of the instrument. We think that the example of jet fuel and crude oil benchmark developed in paragraph B 15 can be an appropriate starting point for a more conceptual approach of that topic.

Further, we believe that it is not appropriate for the Board incorporate opinions within the standard as to whether risks are "reliably measurable", such as those relating to credit risk, prepayment risk and inflation. We believe that such statements will inevitably lead to a more rules based application of the standard, which we believe runs counter to the Board's expressed objective of issuing a more principles-based standard. We note that financial markets continue to evolve and innovate at a very rapid pace and are constantly developing new indices and instruments, such that what may be considered difficult to measure today may become a standardized metric tomorrow. Accordingly, we believe that the Board should set forth the principle that a risk component should be separately identifiable and reliably measurable but should eliminate the references to credit risk, prepayment risk and inflation as not meeting this definition.

We therefore believe that one of the difficulties presently is the measurement of effectiveness that is focused on comparing the changes in fair value of the hedged item and the hedging instrument.

In our view, this choice of methodology should be fine tuned so to achieve hedge accounting that is in line with their internal risk management. This would imply the possibility of using hedge accounting for an inflation component, if the component is not contractually specified, or using credit derivative contracts as hedging instruments.

As an illustration of sub libor issue, a German Bund is a below Libor asset (as of early 2011). When hedging its interest rate risk component, the negative component that should be added to the reference interbank interest rate (ie: Libor based) to obtain the German Bund yield has numerous non-interest rate-based rationales: German Treasury credit risk is deemed low, German Bunds are deemed very liquid bonds (ie: readily sellable), German Bunds are deliverable to European Future contracts…; all of which are *not* related to the interest rate risk that the bank may want to hedge.

As another illustration, a bank is usually able to get sub-libor funding from its commercial activities. This is actually a positive margin for the bank (ie: a 'negative' margin added to libor-based liability). As this margin is not part of the interest rate component hedging relationship, those items should be hedgeable for their interest rate risk component.

The issue of sub-libor is a very important issue since it is at the very core of banking activity. This should be dealt properly within the micro-hedging framework since it will constitute the crux of the macro-hedging framework to be published soon.

Should those requirements remain as is, they would be completely at odds with the Basel III liquidity regulation on banks since banks have to increase their low (ie: below Libor) interest rate bearing liabilities (retail, sme, deposits from cash management activities that are required to be below market rates…), and increase the amount of high quality liquid assets, most of which should be below libor securities.

In other words, with the ED as is, banks would be prevented from hedging their interest rate risk that derive from assets and liabilities that regulation requires them to have and increase: this is most probably a consequence that is not intended by standard setters.

We recommend that:

- the requirements that prevent from hedging below Libor assets and liabilities are dropped, so as to recognize that the negative margins derive from components that are not part of the interest rate risk that is being hedged;

- the hedging framework is:

    - principle-based (i.e.: not rule-base); and

    - consistent with its stated intent to be aligned with actual risk management similarly to what is mentioned in B38 for effectiveness “This means that information (or analysis) used for decision-making purposes can be used […]”.

Inflation should be dealt with similarly to other risk components that can be hedged. There is no reason for B18 to require specific criteria to be met for inflation risk component. As other types of risk components, the inflation risk that is hedged should be identifiable and measurable. The requirement for inflation to be contractually specified should be dropped off.

Again, so as to align as much as possible with the actual risk management of the bank, the identification and measurement of the hedged component should derive from the entity risk management.

Finally, we urge the Board to re-assess its current proposal to not allow hedge accounting for items that are measured at Fair Value through OCI (FVTOCI). We understand that the basis for this restriction is that no P&L would be recognised on this instrument (apart from dividends). However, we disagree with this prohibition on that basis and believe that especially foreign exchange risk (‘FX’) should be allowed to be hedged. This is an important issue for example, in circumstances where the acquisition of a FVOCI instrument is hedged for foreign currency risk using foreign currency denominated funding. Therefore we request the removal of paragraph 4 in the ED which prohibits hedge accounting to FVOCI items.

## DESIGNATION OF A LAYER COMPONENT OF THE NOMINAL AMOUNT

**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?**

We welcome the layer approach according to which a layer component of the nominal amount of an item will be eligible for designation as a hedged item. Indeed, hedging a layer of the nominal amount addresses the fact that there may be a level of uncertainty surrounding the amount and the timing of hedged items for both anticipated and existing transactions. This is aimed to align hedge accounting with risk management strategy.

However, we are disappointed that a layer component of a contract that includes a prepayment option will not be eligible as hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk (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). In a one to one relationship, we can understand the reasoning developed under BC 69, because the behavior of a loan with an embedded prepayment option is not predictable, so the whole range of possibilities must be included in the option valuation. But, we disagree that it can apply to group of hedged items or to portfolios.

In a portfolio, prepayment risk is assessed on a global basis to take into consideration the behavior of all its constituents. That means that under a measurable threshold, based on historical data, the value of the prepayment option is nil, whatever the moves of yield curves.

Under this approach, the bottom layer of the whole loans population behaves as it has no prepayment option embedded. In these circumstances, the value of the prepayment option is nil.

To be around the bottom layer is precisely the purpose of under hedging strategies implemented by banks to address the issue of prepayment risk. So, it is inconsistent to recognize that these strategies are well grounded and to exclude them in the precise circumstances where they are implemented.

Interest rate risk management of prepayable assets usually consists in dynamically hedging the interest rate risk exposure based on expected prepayments that change with market rates. The hedging instruments are regularly adjusted to adapt to changes in expected prepayments. This can be seen as a form of delta-hedging that is possible in the current IAS39-framework. Delta hedging activity is applied to either a portion of the portfolio or a bottom layer of the portfolio. In the latter case, the hedging instruments are before the fact adjusted only to the extent that expected balances are lower than the bottom layer that is being hedged.

The hedging framework that is suggested by this ED is very consistent with actual interest rate risk management: whenever needed, hedging instruments are rebalanced so that the hedging activity remains consistent with the objective of the hedge. In that respect, there is no reason to prevent bottom layer to be hedgeable when it may be affected by changes in expected prepayment when rebalancing is required.

More precisely, delta-equivalent delta hedging strategy is consistent with:

- B59: "An entity may rebalance a hedging relationship if it aims to ensure that the hedging relationship will continue to meet the objective of the hedge effectiveness assessment"; and

- B47: "If a hedging relationship ceases to meet the objective of the hedge effectiveness assessment, or is expected to do so, an entity determines whether the risk management objective for that hedging relationship remais unaltered. If so, the hedging relationship is adjusted so that the new hedge ratio again meets, or is no longer expected to cease to meet, the objective of the hedge effectiveness assessement (rebalancing). Rebalancing is accounted for <u>as a continuation</u> of the hedging relationship in accordance with paragraphs B48-B60."

… subject to ineffectiveness be recognized at rebalancing date as stated in:

- B47: "[…] On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised in profit or loss immediately before adjusting the hedging relationship"

… with ineffectiveness derived from the bank risk management.

This is the reason why hedging a bottom layer of a prepayable item should *not* be excluded but be subject to the other requirements in the ED. Excluding bottom layer hedging for prepayable items would inconsistent with both the rest of the text and with the intent of the text to be consistent with actual risk management activities.

Further, we would like to stress that since the actual risk management of prepayment risk is carried out by using a combination of underhedging and purchase of interest rate options (i.e. Bermudan swaption, European swaption.), the final standard should comprehend such market techniques.

By lending fixed rate prepayable mortgages, banks sell options to its "irrational" customers. So the obvious way of hedging such exposure requires buying such options from "rational" market counterparties. The difference in "rationality" leads to the development of behavioural model which should optimise the purchase of options from the market

## HEDGE EFFECTIVENESS REQUIREMENTS TO QUALIFY FOR HEDGE ACCOUNTING

**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 welcome the simplification of the methodology and the elimination of the bright line 80-125.

We welcome B34 statement that "… when the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to conclude o the basis of a qualitative assessment of those critical terms that the hedge ineffectiveness, if any, would not be expected to produce a biased result")

We welcome B38 statement that "An entity's risk management is the main source of information to perform the assessment whether a hedging relationship meets the hedge effectiveness requirements." since it helps ensuring the alignment between actual risk management and accounting treatment.

As a consequence, the hedge relationship will in fact only be re-balanced as and when the risk management limits are breached or about to be breached. We believe it was the Board's objective to allow for fluctuation of the relationship between the hedging instrument and the hedged risk within the parameters of the associated risk management strategy. Therefore, we suggest that this criterion be re-stated in the context of the risk management strategy (see further our comment to Question 7 regarding re-balancing).

We agree that a hedge relationship would provide a biased result if it reflects a deliberate mismatch with the hedged risk. However, a deliberate mismatch should generally not exist to the extent a company acts in accordance with a strategy to reduce volatility. We are concerned that the use of the words "un-biased" may be interpreted with unnecessary rigor toward absolutes which are inconsistent with risk management judgment. Thus, we propose that this language be replaced with a principle linking the effectiveness directly to the risk management strategy.

We note that a hedging relationship must produce an "unbiased" result and minimize expected hedge ineffectiveness: effectiveness assessment focuses on the hedge ratio, which has to be set in order to minimize ineffectiveness and will be expected to achieve other than accidental offsetting. Clarifications are need, notably as to the meaning of "unbiased result". It can be interpreted as institutions must systematically adjust their derivatives positions in order to be 100% effective. This is not the way risk management is internally defined. Every hedging manager works within risk limits (often completed with stop losses limits) and do not rebalance his books systematically as long as they remain within the defined ranges.

The concept of a "hedge ratio" works in circumstances where a specific transaction is being hedge, but this is not consistent with the more general framework of hedging interest rate risk

as a whole. As mentioned before, the choice of a methodology should be fine tuned so to achieve hedge accounting that is in line with their internal risk management

We agree that a hedge ratio cannot be deliberately manipulated in order to achieve views on the evolution of changes in value of the hedging instruments.

## REBALANCING OF A HEDGING RELATIONSHIP

**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?**

a) Subject to the notion of risk limits exposed above, we agree that current practice is to rebalance the hedging relationship when it is required by markets changes: rebalancing is a matter of fact based on the risk management strategy applied rather then a matter of accounting; if the risk management strategy itself does not require re-balancing at a particular level of volatility, we do not see the conceptual substance of a re-balancing requirement resulting from the application of accounting standards.

   We would also like to point out that for many entities there is a link via internal contracts between the external hedged item and the external hedging instruments. The processes proving these matches are well established and documented. It is possible that the (disallowed) internal trades perfectly match the hedged items but examination of the two external items may evidence higher ineffectiveness. It would be unhelpful if this triggered a requirement to re-balance. Under IAS 39 we would more likely de-designate and re-designate a new (tighter) derivative and we would like to continue to carry out this practice.

   We agree that changes in hedge relationships must not necessarily lead to de- and re-designation processes. De- and re-designations are mainly an issue of the consideration of take-on RVs in cash flow hedge accounting where existing hedging instruments have a take-on RV whereas the hypothetical derivative constructed does not. The Board may rather want to address this specific issue and allow voluntary de- and re-designations (see Question 8).

b) The same answer as above.

## DISCONTINUING 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?**

We understand the necessity of de-designating the hedge relationship if it does no longer meet the qualifying criteria or the risk management objective. However, we note that because the risk management objectives are often not directly linked to individual assets or liabilities and may have multiple goals, a change in risk management strategy with respect to an individual hedge relationship is not always easy to identify. Therefore we would urge the Board to take up this issue as part of its deliberations on the phase 2 of the hedge accounting project.

It is difficult to answer to this question without knowledge of the intended scope of rebalancing. Under the current standard, discontinuation by bank is used as a substitute for appropriate principles to deal with dynamic hedging and failure to provide hedge accounting rules that are in line with risk managment. As the portfolio of hedged items evolved between two balance sheet dates, terminations and re-designations are made to cope with these changes and to adjust the hedging position.

Rebalancing can or cannot encompass this strategy, depending on what the limits of this concept are. To be operational in the circumstances we referred to, it must allow modifying the derivatives' exposure to cope with the changes in the balance sheet, according to the risk management strategy.

We note that because the application of hedge accounting is voluntary the cessation of hedge accounting should also be voluntary. We do not understand the Board's concerns that hedge accounting may be misused for purposes of earnings management. Allowing discretionary designation and de-designation does also not encumber comparability; rather it allows appropriately reflecting different approaches to risk management in the financial statements.
It is imperative that an entity have the ability to dedesignate voluntarily. This would be absolutely necessary to achieve reasonable results.

## ACCOUNTING FOR FAIR VALUE HEDGES

**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) The proposed accounting scheme for recording fair value hedges is obviously more complicated than the existing one and will need costly IT system adaptation. In return, we do not see any improvement in the information provided to users. The outcome of hedging strategies can not be understood by taking only into consideration aggregate figures, but by appropriate disclosures. So, it is not meaningful to focus only on the presentation of financial statements to improve the understanding of these matters by outside stakeholders. The current proposal is better than going back to the previous tentative decision to use CFH accounting mechanics for FVHA.

b) Adding several lines to the statement of financial position will not improve its clarity. We think that all fair values' adjustments must be displayed on one line, with the breakdown by items provided in disclosures.

c) We agree

## ACCOUNTING FOR THE TIME VALUE OF OPTIONS FOR CASH FLOW AND FAIR VALUE HEDGES

**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) Agree

b) Agree

c) The requirement of «Aligned time value" add complexity, without portraying adequately the relationship between the hedged exposure and the optional hedging instrument. Other factors than critical terms are taken into consideration to set up the more effective hedge, like greeks and the liquidity of the markets for various options. We understand the Board's objective when introducing such concept, but it needs some more work to be operational and a cost benefit analysis thereafter to determine the balance between added complexity and improved information.

## HEDGES OF A GROUP OF ITEMS

**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?**

Agree

## PRESENTATION

**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?**

Agree

## DISCLOSURES

**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?**

(a) We agree with the general principal set up for disclosures by paragraphs 40 to 44, 47 and 48. However the list of required quantitative information in the following paragraphs (e.g., 45 and 46 and 49 to 52) is far more problematic: we doubt of any added value of numerous amounts required, as they do not portray adequately the risk reduction effects provided by hedging strategies. Past performance of hedging strategies have little predictive value as they are related to former exposures, which can only be accidentally representative of the existing risks. Alternatively, we suggest focusing disclosures on sensitivities of risks exposures. Moreover we are not aware that users of our financial statements have issue with the existing disclosure framework for hedge accounting and as such do not see the value in these disclosures. Moreover the prescribed disclosures would be, from a practical perspective, very onerous for preparers to collect.

In summary we question whether, based on a cost benefit analysis, paragraphs 45 and 46 and 49 to 52 are justified and therefore ask the Board to remove these requirements.

(b) We do not believe that appropriate disclosures can be decided upon however until the question of the linkage between risk management and hedge accounting is known (e.g., after phase 2). However in general we believe that the wording of the eventual disclosure requirements must not be too prescriptive, to allow flexibility for institutions in order to portray adequately various circumstances in which risk management strategies are developed.

## ACCOUNTING ALTERNATIVES TO HEDGE ACCOUNITNG

**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?**

N/A

## ACCOUNTING FOR CREDIT RISK USING CREDIT DERIVATIVES

**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?**

**(a)**

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.

We think that the three alternative treatments are complicated: alternative 3 could represent a starting point to build a coherent HA framework 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).

**(b)**

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."
A comprehensive solution should consider the possibility to implement hedge accounting for the hedge of credit risk at portfolio level.

## EFFECTIVE DATE AND TRANSITION

**Question 16**

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

We are of the view that key standards impacting upon financial services activities should have a single adoption date, in order to maintain comparability and to cope with the systems ‘developments inherent to the implementation of complex new texts. In our answer to the request for views on effective dates and transition methods, we have suggested that January 2015 be the effective date with no restatement of the previous years.

Further, we believe that the classification and measurement and hedge accounting phases of the financial instruments project are inter-dependent. When considering application of the proposed hedge accounting model, entities will need to consider the cost/benefits associated with the new model versus application of the fair value option. It is imperative that entities be allowed to elect the fair value option when they become subject to the new hedge accounting model. As such, preparers should be allowed to adopt classification and measurement and hedge accounting simultaneously. Those entities that have already adopted classification and measurement should be afforded the opportunity to early adopt hedge accounting once finalized. Thus, we would encourage the Board to consider an exception with respect to the hedge accounting guidance if it chooses to generally prohibit early adoption.

Contact Person: r.kaiser@ebf-fbe.eu
Related documents: