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EACB Comments on IASB Exposure Draft on Hedge Accounting

9 March 2011

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General Comments

The members of the European Association of Cooperative Banks (EACB) are pleased to comment on the Exposure Draft on Hedge Accounting (ED/2010/13) published by the International Accounting Standards Board in December 2010.

The members of the EACB generally support IASB proposal, which establishes a more objective-based hedge accounting model. The ED proposes positive developments including the alignment of risk management and hedge accounting regulations. This approach has the benefit of being consistent with the role of the business model in the classification of financial instruments.

Moreover, the ED proposals remove a number of the restrictions to hedge accounting in IAS 39 Financial Instruments: *Recognition and Measurement*. There are important improvements relating to assessing hedge effectiveness:

- EACB particularly supports the elimination of the bright lines 80-125 which forces companies to prove that the effectiveness of the hedging relationship between two transactions will be more than 80% but less than 125% effective.

- Our members also appreciate the possibility to designate derivatives, risk components and net positions as hedged items, and the possibility to apply hedge accounting to components of non-financial items.

- The treatment of time value of option as a cost of hedge, avoiding undue volatility in profit or loss

These proposals make the hedge accounting model significantly more flexible, and will contribute to increase the appropriate use of hedge accounting.

However, while EACB members consider that the reference to risk management is a step in the right direction, we think nevertheless that the ED still contains a number of restrictions, which would create inconsistencies with risk management practices. Therefore, we would like to draw the attention of the Board on the following points:

<u>Need for clarifications</u>

EACB members find that some proposals are too complex and could therefore raise operational difficulties, notably:

- The distinction between rebalancing and discontinuation is not clearly defined and the follow up of several mandatory rebalancing might be burdensome;

- EACB members ask for a simplification of the detailed treatment and application guidance regarding the time value of options;
- Our members do not see any added value in the proposed accounting mechanism for fair value hedge based on a two-step approach (OCI and transfer in P&L).

Consequences of the designation of derivatives as hedged items

While EACB members generally welcome the introduction of a hedge accounting objective and the alignment of risk management with hedge accounting regulations, we regret that the restrictions regarding the classification as hedged item/hedging instrument avoid a comprehensive alignment.

This is mainly the case since the IASB decided to exclude internal derivatives from hedge accounting, even though they are a primary part of banks' risk management. Consequently, banks' risk management and the IASB's suggestions for hedge accounting are based on two very different concepts. We believe that only parts of a bank's risk management can be reflected in the financial statements using the concept proposed in the ED. Therefore, we suggest that the termination of hedge-relationships remains voluntary, especially to help avoiding accounting mismatches.

Moreover, our members have strong concerns regarding the restrictions on instruments with prepayment options that could preclude financial institutions from designating a hedge items if an entity use the layer approach. This exclusion is in practice disadvantageous for banks, since many financial instruments (e.g. mortgage loans) have contractual prepayment options. Therefore, hedging of the interest risk would not be possible. Moreover, since the future hedging rules on a macro hedge basis of those instruments with prepayment options has not been clarified yet, we regret to not be in position to assess the regulations conclusively.

Prohibition of hedging credit risk

EACB members do not support that it is difficult to qualify as hedged items risk components of financial instruments such as non contractual inflation or that credit risk is contradictory with the principles proposed for non-financial items. Instead our members think that hedge accounting for credit risk is achievable and therefore that the credit risk should be considered as a risk component. The opinion expressed in the ED 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 two qualifying criteria for a risk component.

In general, EACB members do not understand why the IASB has chosen to add rule-based exceptions to this principle-based ED.

Prohibition of hedging items with not impact on P&L

EACB members disagree with the prohibition of designating as hedged item that will not impact P&L such as equity instrument designated at fair value through OCI (with no recycling), which is not consistent with sound risk management practice consisting in hedging an economic exposure (such as the foreign exchange risk of equities).

Moreover, we reiterate that this prohibition is directly linked to an inappropriate treatment under the phase I of IFRS 9, which should be amended.

Macro hedge accounting

The basic hedge accounting objective for banks is to lock interest margin between the assets and liabilities. In order to manage their risk, banks normally operate on an open portfolio basis including deposits liabilities (term and core) and loan assets with different interest basis. However, the ED only focuses on hedge accounting for non-bank corporations in the context of groups of items that constitute gross or net positions in closed portfolios.

Therefore, EACB members are concerned how this proposed general accounting model will affect to more complex portfolio hedging models. Moreover, we anticipate the following area for further development:

- The eligibility of embedded derivatives as hedging instruments;
- The inconsistency between the irrevocable nature of a fair value option and the optional nature of hedge accounting; and
- The eligibility of equity instruments measured at fair value through other comprehensive income as hedged items.
- Moreover, EACB members have strong concerns regarding the prohibition of designating of risk components when this component will exceed the total cash flows of the hedged item. Therefore, we would like to stress the

importance to further consider the so-called "sub-LIBOR issue", which is of major importance for the banking industry.

Therefore, we urge the IASB to develop a non-complex hedge accounting model for open portfolios, which would be based on risk management objectivities. Furthermore, we believe that the IASB should conduct field-testing and outreach activities to ensure that proposals can be operationalised.

To conclude, given the importance of macro hedging, EACB members believe that the IASB should not finalise a standard on the general hedge accounting model, before developing a model for macro hedging.

Moreover, considering that considerable interdependencies exist among the phases of the IAS 39 replacement (particularly the amortised cost and impairment phase and macro hedging), EACB members believe that the IASB will need to consider the entire package of proposals before finalising the resulting standards. In general, preparers need time to conduct a comprehensive analysis of all the proposed IFRS 9 regulations.

Therefore, we urge the IASB to publish the ED on macro hedge accounting soon, in order to allow banks the assessment of the interdependencies as well.

Please find below our responses to the ED questionnaire.

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EACB responses to the ED questionnaire

Objective 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?

EACB generally welcome the introduction of an objective for hedge accounting. We agree with the direction of the proposed objective to reflect, in the financial reporting, the extent and effects of an entity's risk management activities.

However, EACB members do not believe that hedge accounting should be only restricted to risks that affect P&L. We understand that the IASB decided not to permit hedge accounting of risks that affect OCI because it could result in reclassification of gains or losses out of OCI to profit or loss. However, we believe that it is possible to engage in meaningful management of the risks, which are reflected in OCI or equity. Therefore, we would like the IASB to reconsider particularly this proposal.

Moreover, prohibiting the use of internal derivatives for hedge accounting is not consistent with the way banks manage their risks. It is not common practice for banks to directly relate the single exposures of the banking book with corresponding external hedging instruments. Therefore, EACB members ask the use of internal derivatives to be allowed for hedge accounting purposes.

In addition, we underline that the key issue for financial institutions is portfolio hedging which is not addressed in this ED. In this respect, we emphasise the importance of applying the same objective to open portfolios. Currently in certain situations, preparers have to make artificial hedge designations to achieve hedge accounting based on accounting rules and not based on risk management objectives.

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?

EACB welcomes the extension of the range of eligible hedging instruments to include non-derivative financial instruments, because it enables an entity to align its hedge accounting closer to its risk management objectives.

In this respect, we are convinced that it is not the type of instrument that should determine the qualification as hedging instrument, but the possibility to actually reduce the risk. Therefore, we think there is no conceptual basis for excluding as eligible hedging instruments any non-derivative financial instruments that are not at fair value through profit or loss.

In particular, we believe that the Board should consider the possibility to further extend the range of eligible hedging instruments (e.g. equity investments designated as at fair value through OCI, financial instruments at amortised cost, disaggregation of non-derivative hedging instruments into components other than foreign currency risk). In fact, where such instruments would be designated as at fair value through P&L to serve as a hedging instrument in accordance with an entity's risk management strategy, it would not be possible to revoke that election subsequently if that were to be in line with a change in that entity's risk management strategy.

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?

EACB members agree that an aggregated position that is a combination of another exposure and a derivative should be eligible for hedge accounting. We believe this change from IAS 39 would simplify hedge accounting for example in situations where foreign exchange risk and interest risks are managed separately. We support this approach as it allows hedge accounting to be more closely aligned with actual risk management practices.

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?

EACB members agree that entities should be allowed to designate a risk component as the hedged item for both financial and non-financial items. Moreover, we support that the risk component should be separately identifiable and measurable to be eligible for hedge accounting.

We support that contractually and not contractually specified risk components should be both eligible for hedge accounting. However, we would appreciate some additional clarification on what is meant by risk components that are "implicit in the fair value or cash flows of an item of which they are part". Actually, we think the guidance is not clear enough in order to determine for example whether an interest rate risk in insurance contract liabilities could be identified as a risk component. Further clarification is needed whether a basis risk component is a separately identified risk component (i.e. whether a basis swap -receive 3 month Euribor; pay 1 month Euribor- could be designated as a hedging instrument of a floating rate debt that pays 3 month Euribor).

Besides, EACB members are convinced that the credit risk should not be excluded per se. In practice, economic hedges of credit risk are not always absolute. However, the main components of the hedged item and hedging instruments of credit risk hedges often overlap and therefore there is a correlation between the fair value changes of the hedged item and the hedging instrument. Whereas, considering some complex instruments the credit risk may not be separately, identifiable and reliably measureable, credit risk of most instruments can be easily identified. In addition, it is common practise to recognise the ineffectiveness in the income statement anyway. Therefore, we think that allowing this kind of hedge would enhance the alignment with risk management.

Moreover, we disagree with the restriction that the hedged component must be less than or equal to the total cash flows of the asset or liability and therefore, for example LIBOR component cannot be designated as hedged item if debt instrument is issued at LIBOR less a negative spread. We believe that this would prohibit hedge accounting for existing basis differences such as basis spreads.

Furthermore, we disagree with the restriction that inflation is not separately identifiable and reliably measurable risk component unless it is contractually specified. We believe this would prohibit hedge accounting for valid hedging strategies.

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?

We support the qualification of layers as hedged items.

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?

EACB members disagree with the exclusions of instruments with prepayment options for two reasons for the following reasons:

- In general, we do not think that a principle-based standard should not include rule-based exemptions;

- Moreover, we think that the exemption prevents the synchronization of risk management and the presentation of economic hedges in the financial statements. Since economic hedges of instruments with prepayment options factor the optional component, we therefore think that instruments with prepayment options should be eligible for hedge accounting.

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?

EACB welcomes the removal of the 80 to 125 per cent bright line test for assessing and measuring hedge effectiveness. The elimination of this requirement would simplify implementation of hedge accounting and align it closer to the bank's internal risk management.

We agree also with the elimination of retrospective hedge effective testing. Actually, if the internal risk management assumed a perfect micro hedge, and the ineffective portion of the fair value changes of the hedged item/hedging

instrument is recognised in the income statement, we reckon that a qualitative effectiveness assessment at the date of designation is sufficient.

However, we are concerned about potential inconsistencies that the proposed guidance on the method of assessing effectiveness and measuring ineffectiveness may create:

- We disagree with the requirement that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness as stated in Paragraph B29. Moreover, our experts would appreciate a clarification of the term "unbiased result".

- We disagree with the requirement that the hedge relationship should achieve other than accidental offset as we believe that the concept of "other than accidental offset" is not clear enough. We are concerned that when all used phrases (i.e. unbiased results, other than accidental offset and minimise the expected hedge effectiveness) are read together, the resulting "risk" definition might be a narrow risk interpretation and could in practice lead to a rule-based approach to assess hedge ineffectiveness. EACB members understand that a separate risk component can be designated as a hedged item. However, in order to calculate the ineffective part, it is required to compare the full fair value changes of the hedging instrument (including all risk components) to the fair value changes of the hedged item. We believe that the proposed requirements for hedge effectiveness make it difficult to designate a separate risk component as a hedged item in practice. For example most of the OCT derivatives are uncollateralised instruments. As stated in B31, a decline in counterparty credit rating would fail hedge accounting even though risk management objective would be still achieved and only interest rate risk of the hedged item would have been designated as a hedged risk component.

Therefore, EACB members would welcome additional guidance on how to measure hedge ineffectiveness.

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?**

In principle, EACB members support the concept of "rebalancing" since risk management is a dynamic process, which requires flexible regulations. Rebalancing replaces the voluntary de-designation of hedge relationships enabling an entity to reflect in hedge accounting the changes in hedge ratio that it makes for risk management purposes.

However, EACB cannot support this replacement because the notion of "rebalancing" is not yet well understood enough. For instance, we consider that it could only be used for economic hedges, which are correctly presented in the financial statements. Since this objective is not achieved by the proposed regulations, voluntary de-designation should therefore continue to be allowed to reduce accounting mismatches. In addition, we believe that rebalancing should be voluntary.

Typically, we would recommand that the rebalancing proposals should be subject to appropriate field-testing before finalisation.

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?**

EACB members agree that entities should be required discontinue hedge accounting if the hedging relationship ceases to meet the qualifying criteria.

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?

EACB disagrees as starting and stopping of hedge accounting should be voluntary.

We think that discontinuance of hedge accounting would otherwise achieved by closing the hedging instrument and replacing it with a new one. Actually, sometimes it is practical to discontinue hedge accounting earlier for example when forecasted sales occurs rather than to continue hedge accounting until the actual payment date. Allowing banks to voluntarily de-designate hedges would present another possibility to reduce accounting mismatches. As mentioned before, the restrictions on qualifying hedged items/hedging instruments especially the exclusion of internal derivatives from hedge accounting– creates a divergence between risk management and financial reporting. Prohibiting the voluntary de-designation of hedge relationships increases the possible divergence/accounting mismatches. Therefore, we believe that this practice should be allowed and not add complexity to hedge accounting.

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?

EACB believes that the proposed mechanism to recognise the fair value changes of hedged items and hedging instruments first in OCI and then transfer the ineffective portion to profit and loss does not provide any additional useful information as compared with current requirements to disclose the ineffectiveness in the notes.

Our members think that this proposal is unnecessarily complex. Instead, we are in favour of recognising the gains or losses on the hedging instrument and the hedged item directly in the income statement. The effective portion will be cancelled out and the remaining portion represents the ineffectiveness.

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?

EACB members understand the IASB's intent to separate carrying amounts and hedge adjustments in the statement of financial positions. However, we think that showing the separate hedge adjustment for every financial position which includes hedged items does not enhance the understandability of the financial statements.

Moreover, statement of financial positions should allow a summary of the assets as well as liabilities and equity of a company. Therefore, in order to keep this main function of the statement of financial positions, EACB suggests a single separate line item, which includes the net hedge adjustments. A more detailed presentation of the hedge adjustments could be provided in the notes.

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?**

Our members are sceptical towards the introduction of linked presentation. This concept seems to reduce comparability of the financial statements of different companies and potentially confuses the readers of financial statements.

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?**

EACB supports the IASB's suggestion to deal with the ineffectiveness arising from the time value of an option.

However, we think that introducing two different concepts to recognise the time value adds unnecessary complexity. Therefore, we would suggest the development of a single and simple approach for the reclassification of the time value to P&L.

The analogy of the time value of an option and an insurance premium seems appropriate.

Hedges of a group of items

Eligibility of a group of items as the hedged item

Question 11

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

EACB members are in favor of the eligibility of groups and net positions for hedge accounting.

However, we underline that a comprehensive assessment is not possible before the publication of the Board's proposals in respect of macro hedge accounting.

In fact, a main component of the internal risk management of banks is the hedging of net interest positions. Many instruments include prepayment options and therefore the internal risk management also considers those prepayment options. The exclusion of instruments with prepayment options from hedge accounting limits the possibilities to align risk management and financial reporting on hedge accounting. As this is counterproductive to the ED's objective, we think that the restrictions concerning prepayment options should be eliminated.

Furthermore, the IASB's concept of groups of hedged items seems to be based on a group, which does not change. However, in practice, banks rather managed

their portfolios on a dynamic basis and instruments do not remain in the same portfolio until maturity.

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?

EACB agrees with the proposals regarding the presentation in profit or loss of the effects of hedge accounting for groups of items.

However, we disagree with the way gains or losses from fair value hedges of net positions are proposed to be presented. Banks usually do not mange risks separately for different classes of financial instruments but for separate risk components of all financial instruments. Therefore, we believe that the separate presentation of hedging instrument gains or losses for each line item is counterproductive for aligning risk management and hedge accounting.

Thus, rather than requiring presentation on a gross and disaggregated basis in the statement of financial position, we would recommend that all fair value changes be aggregated into a single item in the statement of financial position and to provide details in the notes.

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?**

We generally agree with the disclosure requirements and support the possibility of cross-referencing.

However, we are concerned about the prescriptive nature of the disclosure requirements and the possible interaction with IFRS 7. Therefore, we would prefer that the disclosure requirements would be principle-based and would follow the general objective of IFRS 7 i.e. to allow management judgment in order to prepare meaningful financial information.

Accounting alternatives to hedge accounting

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative

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 proposed change, as it will enable some entities to better reflect the risk management strategies applied. We expect however that this will not benefit more than a limited number of industrial entities.

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?**

In our view, the alternative accounting treatments to account for hedges of credit risk are too complex. A set of principle-based regulations should be advanced enough to display all occurring risk management strategies. Therefore, we suggest that economic hedges of credit risk should be eligible for hedge accounting.

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?

Most EACB members are of the view that key standards on financial instruments should have a single adoption date. 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.

However, some of EACB members consider that the IFRS 9 new classification requirements have to be applied retrospectively seeing advantages to early apply the standards. Those members do not support the prospectively application, which would lead to more accounting mismatches not adequately reflecting the existing economic hedges:

They take the following example: a financial instrument, for which the fair value option under IAS 39 was applied, was economically hedged with a corresponding derivative. For this case, the economically hedged item and the hedging instrument were both measured at fair value and hedge accounting was not necessary since there was no accounting mismatch. If this financial instrument has been measured at amortised cost under IAS 39 the company would have designated a hedge relationship to reflect the economic hedge. Applying the proposed hedge accounting regulations (ED) prospectively, the company would not be able to reflect that the economic hedging relationship existed before the initial application of these regulations. Furthermore, for financial instruments, which were hedged under the portfolio hedge accounting regulations of IAS 39, and will be measured at fair value under IFRS 9, the ED does not specify how to deal with the hedge adjustments recognised as separate line item under IAS 39.

Therefore, EACB members think that it is necessary to implement more flexible transition regulations, which allow preparers to reflect the economic reality better and do not create new accounting mismatches.

End.