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Dear Sir David

Exposure Draft ED/2010/13 Hedge Accounting

Lloyds Banking Group plc welcomes the opportunity to comment on the proposals contained within this exposure draft (ED).

We are broadly supportive of the objective of the ED to simplify the application of the current IAS 39 hedge accounting requirements and, in particular the move towards a more principles-based rather than rules-based approach. However, this phase of the IAS 39 replacement project ('phase 3') is incomplete and we need to understand the broad direction of the macro hedging proposals, which are particularly relevant to the banking industry. The comments we make in this letter should therefore be regarded as being subject to the outcome of the macro hedging proposals. We encourage the Board to re-expose all aspects of phase 3 when finalising the macro hedging proposals so that we may comment on the hedge accounting proposals as a complete package.

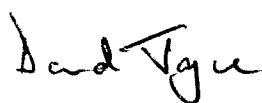
We have a number of specific concerns with the proposals in the ED which we set out below.

- **Risk management objective.** We believe that the objective of hedge accounting does not adequately address risk management practices within a banking environment where there is a disconnect between risk management and hedge accounting. Banks consider their risk management predominantly at a macro or portfolio level meaning that the majority of risk management decisions, including whether or not to undertake hedge accounting, are not undertaken in isolation. Banks manage the economic risks on a separate portfolio basis between the trading and banking books, both of which carry very different risk management strategies. We believe that further clarification of the objective of hedge accounting is necessary to ensure that hedge accounting currently undertaken by banks is not precluded because hedge accounting activities and risk management practices are not aligned. In addition, there are instances where it is not possible to create a hedge accounting relationship that is aligned with risk management practices, such as in the case of hedging of demand deposits.

- **Voluntary de-designation.** We do not believe that the proposals in the ED should prohibit the ability to voluntarily de-designate a hedge accounting relationship. This assumes that risk management is performed on a micro rather than portfolio basis as in a banking environment. There are occasions within a banking environment, where we consider that voluntary de-designation is operationally the most appropriate approach to adopt. While we note the Board's intention to create simplicity for hedge accounting and enhance comparability between different entities, we do not believe that restricting the use of voluntary de-designation will achieve this when ultimately the adoption of hedge accounting still remains one of choice.
- **Fair value hedge accounting.** We do not believe that there are any benefits for users of the financial statements of changing the way in which fair value hedges are currently accounted for. The proposals in the ED will still require ineffectiveness to remain in the income statement for fair value hedges but there is a gross-up within other comprehensive income for the change in fair value of the hedged item and hedging instrument. We believe that the current IFRS 7 disclosure requirements are adequate to ensure that users are provided with information about the gross change in fair value of both the hedged item and hedging instrument impacting the income statement.
- **Hedge effectiveness assessment and rebalancing.** We would suggest that the term bias is defined further in order to avoid any interpretations of this leading to an onerous 'no bias' requirement. We do not believe that rebalancing should be mandatory where a hedge relationship no longer meets the objective of the hedge effectiveness assessment but continues to meet its risk management objective. We believe that this could lead to frequent rebalancing which is likely to be operationally burdensome for entities and, in addition, may lead to situations where the accounting does not reflect the risk management objective of the hedging relationship.
- **Status of IAS 39 Implementation Guidance.** The Implementation Guidance to current IAS 39 provides substantial guidance and clarification on many hedge accounting issues. The status of the implementation guidance is unclear and we believe that the Board, as part of their outreach activities should clarify which guidance might be carried forward to the new standard. We believe there are a number of important guidance documents which should remain as they articulate the Board's intention as to how an entity should apply hedge accounting.

In the meantime, we would encourage the Board to continue its outreach activities with respect to these matters before concluding on a final standard.

Yours sincerely



David Joyce

Appendix 1

Responses to questions in ED

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?

In answering this question, we believe that the practice is currently widespread for entities to have different risk management strategies for hedge accounting purposes and for economic hedging purposes. We believe that some further clarification of the linkage to risk management is required to ensure that common risk management activities undertaken by financial institutions are not precluded. For example:

- managing income statement volatility arising from the banking book (intra-group derivatives) typically uses trading book derivatives to best represent the banking book transactions for hedge accounting purposes
- for (macro) cash flow hedge accounting within a banking environment, the economic risk arises from fixed rate assets however the hedge accounting is centred on the funding of those assets. This is relevant where banking book derivatives are transacted for asset and liability management purposes. Typically the underlying assets and liabilities that are being economically hedged are either difficult to designate in a hedge accounting relationship due to factors such as prepayment or high volumes such as in the case of personal loans, or they may not be eligible as hedged items such as demand deposits
- using only fixed rate mortgages in a macro fair value hedge accounting relationship to mitigate volatility arising from banking book (intra-group derivatives) which have been transacted to economically hedge a number of different types of retail assets and liabilities
- an entity's risk management strategy might use derivatives to economically hedge its overseas profit but in order to mitigate the accounting volatility arising from the derivative the entity designates a net investment hedge accounting relationship.

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 believe that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss (FVTPL) should be permitted as an eligible hedging instrument as this might be consistent with an 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?

We welcome the Board's intention behind this proposal although we believe that further clarification is required on the following matters:

- *Whether the derivative designated as a hedged item remains on a fair value measurement basis.* We believe that it is still the intention of the ED that all derivatives should be measured on a fair value basis. However, we would ask that the Board clarifies that the final wording in the standard makes it clear in respect of derivatives designated as hedged items that this is still the case.
- *Whether this approach is intended to be for all types of hedging relationships i.e. cash flow and fair value hedges.*
- *Implementation guidance on specific examples as to how this approach may be used for each specific hedging relationship.* For example, we have interpreted this as being particularly relevant in a situation whereby an entity has a forecast debt issuance in a non-functional currency which will be hedged by a cross-currency swap back to its functional currency. The entity thereby considers that it has a forecast 'synthetic' debt issuance in its functional currency (comprising of the forecast debt coupled with the forecast cross-currency swap). The entity is likely to transact a single interest rate swap in its functional currency to hedge its forecast interest rate risk arising from the aggregated forecast exposure.

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?

We recognise the significant benefits that this change brings to non-financial services entities. However, from the perspective of a financial services entity, we have the following comments:

- We believe that the ED should permit Libor to be a designated hedged risk, whether the Libor cash flows are lower than or greater than the total cash flows of the asset or liability. In the case where the Libor cash flows are greater than the total cash flows of the asset or liability (sub-Libor issue), then as long as it can be demonstrated that the risk component is a separately identifiable component of the asset or liability then Libor should not, in this instance, be prohibited from being the designated hedged risk. We believe that further clarification is necessary in respect of the 'sub-Libor issue' in relation to both financial and non-financial instruments.
- In addition, we would ask the Board to clarify that the wording of the ED would now permit a single currency basis swap (e.g. receive 3 month Libor; pay 1 month Libor) to be designated as a hedging instrument of a floating rate debt (e.g. 3 month Libor). This is due to the fact that the risk component, i.e., basis risk, is a separately identifiable component of the hedged item.

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 proposal in the ED that permits a layer component of the nominal amount of an item to be designated as a hedged item. We understand this to also be relevant for groups of items as well.

With regards to a layer component of a contract that includes a prepayment option, we are anticipating this to be permissible under the macro hedging proposals. Therefore we need to consider the proposal under this ED with the macro hedging proposals when those are published.

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 a number of the proposals set out in the ED, such as:

- removing the 'bright-line' requirement of the 80-125% test for assessing and measuring hedge effectiveness, and
- permitting qualitative effectiveness assessment.

However, we believe that the Board should clarify the matters set out below:

- Paragraph B29 requires the hedge effectiveness assessment to demonstrate that the hedging relationship will produce an unbiased result. Although the paragraph goes on to state "... this does not mean that a hedging relationship has to be expected to be perfectly effective in order to qualify for hedge accounting", we believe that further guidance in relation to the requirements of this paragraph would be helpful.
- It is not clear whether the ED permits hedge effectiveness testing either through comparing the change in fair value of the hedging instrument and hedged item, and/or through comparing cash flows (undiscounted) of the hedged item and hedging instrument.
- It is not clear whether the proposals in the ED intend that hedge ineffectiveness must be assessed for a hedging relationship that is considered to be 100% effective for risk management purposes. For example, changes in the credit rating of a swap counterparty will generate ineffectiveness within the hedge effectiveness test if the swap is designated in a hedging relationship. However, over the life of the transaction, the swap cash flows may exactly match those of the hedged item and therefore the hedge is considered to be 100% effective for risk management purposes. We would ask the Board to clarify that such a circumstance would not impact the effectiveness assessment

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?

We welcome the proposal in the ED to permit the pro-active rebalancing of a hedge accounting relationship in order that it continues to meet its future objective of the hedge effectiveness assessment. This proposal avoids the complications of de-designation and re-designation of hedges that arises under the current IAS 39. We note that this proposal is non-mandatory in nature as the ED states that an entity 'may proactively rebalance', therefore, the choice remains with the entity as to whether they want to re-balance a hedging relationship or not. The choice as to the action to take may be based on pre-determined parameters established on designation of the hedging relationship.

However, we do not believe that rebalancing should be mandatory where a hedge relationship no longer meets the objective of the hedge effectiveness assessment even though the risk management objective for that designated hedging relationship remains the same.

However, there are instances where it is not clear from the ED whether rebalancing would or would not be permitted or required. The following examples are provided:

- a) *in the case of a fixed rate debt and a receive fixed pay 3 month Libor swap both designated in a fair value hedge.* If the hedging relationship no longer met the hedge effectiveness assessment due to deterioration, within pre-defined parameters, in the swap counterparty's credit rating, would it be permissible or required to:
- substitute the swap for another swap that does meet the hedge effectiveness assessment? Or
 - add another (or proportion of a) swap to improve the hedge effectiveness assessment?

b) *where basis risk starts to impact on a hedge relationship.* A 1 month Libor debt and a receive 3 month Libor, pay fixed rate swap was designated in a hedging relationship when the basis spread between 1 month and 3 month Libor was not material. As the basis spread between 1 month and 3 month Libor has widened the hedging relationship is no longer meeting its hedge effectiveness assessment, therefore, would it be permissible to:

- substitute the swap for a receive 1 month Libor, pay fixed rate swap?
- add a pay 3 month Libor, receive 1 month Libor basis swap (which combined with the original swap creates a 'synthetic' receive 1 month Libor, pay fixed rate swap)?

In addition, we would also observe that if rebalancing is expected to be frequent then this is likely to become operationally burdensome for many entities.

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?**

Once the qualifying criteria have been agreed on within the ED, we would agree with the proposal that an entity should discontinue hedge accounting prospectively when the hedging relationship ceases to meet the qualifying criteria. However, we don't agree with the proposal that voluntary discontinuation should be prohibited and we believe that an entity should be permitted to discontinue hedge accounting prospectively even if the hedging relationship still meets its qualifying criteria such as, for example, where:

- a) the de-designated hedging instrument will economically offset another hedging instrument
- b) the hedge accounting relationship is immaterial and the operational costs of maintaining the hedging relationship outweighs the accounting benefit, or
- c) the original external derivative is no longer the optimal hedging instrument. This is particularly relevant in a situation within a banking environment where a hedge accounting relationship has been designated to manage the income statement volatility arising from a banking book derivative. In order to achieve hedge designation, an external trading book derivative is selected and designated as the hedging instrument in the hedge accounting relationship. In time, the trading book derivative may no longer be the best hedging instrument (perhaps through deterioration in the creditworthiness of the swap counterparty). In this situation, an entity may wish to de-designate the hedge accounting relationship and re-designate with a more appropriate hedging instrument. The original objective of the hedge accounting relationship has remained unchanged (i.e. to manage the income statement volatility arising from the banking book derivative).

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) We do not agree with the proposal that the gain or loss on the hedging instrument and the hedged item should be recognised in OCI and ineffectiveness recorded in profit or loss. We believe that this proposal does not represent an improvement as the ineffectiveness continues to be reported in the income statement. Consequently, we believe that this proposal leads to added operational complexity rather than being a simplification. We believe that adequate disclosure such as provided by IFRS 7 provides the right level of transparency around the gross fair value gains or losses pertaining to the hedged item and the hedging instrument in a fair value hedging relationship.
- (b) We believe that the presentation of gains or losses on the hedged item attributable to the hedged risk for fair value hedges as a separate line item in the balance sheet needs to be reconsidered. To the extent there are fair value hedges of lots of different hedged items, showing a separate line item for each hedged item would make the balance sheet look crowded. A better option would be to show in aggregate all fair value hedging gains/losses on a single line in the balance sheet with further details then provided in the notes to the financial statements.
- (c) We agree that linked presentation should not be allowed. We do not believe that linked presentation creates any further clarity for users of the 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 (e.g. 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 (i.e. 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?

We have no comments on these 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?

We need to consider this proposal in conjunction with the macro hedging proposals when those are published.

Presentation (groups of hedged items)

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 (e.g. 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 that where the hedged item is a net position consisting of gross items that impact different lines in the income statement, then the hedging instrument gains or losses should be recognised in a separate line from those affected by the hedged items.

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 disclosure) and why?**

We believe that there needs to be further clarification as to what is intended to be disclosed about an entity's risk management strategy, how it is applied to manage risk, and how this is intended to tie in with an entity's hedge accounting strategy. This point has also been raised in Question 1 above.

In addition, we believe that the level of disclosure required by the ED is very detailed and prescriptive and it is unclear to us as to what benefits this level of detail provides to users of the financial statements.

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 have no comment on this matter.

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?**

While we recognise that it has been operationally difficult for financial institutions that manage credit risk using credit derivatives to achieve hedge accounting, we nevertheless believe this is one area which the Board should seek to address through this ED in arriving at a workable and pragmatic solution and recommend that further consultation is undertaken as part of the Board's outreach activities.

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?

Consistent with our comment letter on the Request for Views on Effective Dates and Transition Methods, we propose a single effective date of 1 January 2015 for IFRS 9. As we indicated in our covering letter, it is vital that we understand the broad direction of the macro hedging proposals as these will have a significant impact for hedging undertaken in the banking industry. Delays in finalising those proposals could compromise the ability to implement IFRS 9 as a complete package with sufficient time.