



March 9, 2011

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Board Members:

Consejo Mexicano para la Investigación y Desarrollo de Normas de Información Financiera (CINIF), the accounting standard setting body in Mexico, welcomes the opportunity to submit its comments on the Exposure Draft on *Hedge Accounting* (the ED), issued for exposure in December 2010. Set forth below you will find our comments on the topics included in the ED, as well as our responses to the questions included therein.

We have divided our letter in two sections. In the first section you will find our general comments on the ED. The second section includes our responses to the specific questions raised in the ED.

General comments on the ED

In general, we support the efforts of the IASB to simplify and streamline the hedge accounting requirements to better reflect an entity's financial risk management activities and the extent to which those activities are successful in meeting the entity's comprehensive risk management objectives.

We believe there should be guidance on what constitutes adequate risk management objectives and strategies. These should be well defined and should not be so broad that many transactions would fall in the objective or strategy, even though these transactions may diverge in nature and effects from a sound hedging strategy. We propose that the Board include guidelines in this respect so that the objectives and strategies developed by management are specific and not overly broad to avoid having criteria that promote the softening of the requirements needed to qualify for hedge accounting.

We believe that allowing hedge accounting for everything that falls within a broad stated hedging strategy is very risky unless the Board establishes or makes reference to some risk management framework (e.g. Basle Committee's risk framework for financial institutions) and guidelines for what constitutes an acceptable and qualified risk management framework that leads to congruent hedging strategies.

All other concerns are explained in the responses to the specific questions raised in the ED.

It should be noted that we have been asked by some of the Mexican entities visited by Jan Engstrom and Joao Santos during their outreach visit to Mexico in February 2011 to include some of their comments in our response letter. Those comments are presented in italics and are specifically identified in questions 2, 6 and 11, in addition to the following general comment:

A significant issue for the Latin American economies, as opposed to the European economies, is the issue of the functional currency, since the risk management strategies followed occasionally cover transactions in a foreign currency, either the recording currency or the presentation currency. While the functional currency of the group may be the Mexican peso, the risk strategy may be designed to cover cash flows in U.S. dollars; accordingly, it is important that the final standard incorporate this topic to determine if it will be possible to cover risks in all currencies: functional, recording and presentation.

Our responses to the specific questions raised in the ED

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

Yes, we agree with the proposed objective of hedge accounting. However, we believe there should be guidance or a reference framework on which to base an entity's objectives and strategies regarding its financial risk management activities. This could be based on some robust industry risk management framework (e.g. the Basle Committee's risk taxonomy and framework is well known and enforced for Risk Management Compliance in the financial services industry worldwide, and there are other financial risk management frameworks shared in the mining, airline, energy and commodities industries on which to rely). The Implementation Guidance should make reference to such frameworks.

An acceptable and qualified financial risk management strategy should not be whatever the entity wants. We strongly believe that the revised criteria lack rigor, are questionably operational, and could produce unintended consequences. We believe the expansion of the use of hedge accounting to accommodate virtually any assumed or perceived risk management activity is inappropriate and inadvisable. Therefore, we believe that the risk management strategy that an entity establishes must be very precise and focused on the risks that are to be covered. Also, there should be a precise statement on how the entity intends to cover the risks.

If during the discussions at the Board there were papers prepared by the staff regarding what would adequately and clearly state the main characteristics of financial risk management objectives and strategies, these should be included in the Implementation Guidance to capture the spirit on which the Board developed this ED.

We also foresee a potential problem in disclosing the financial risk management objectives and strategies since many entities may be reluctant to extensively disclose their internal risk policies for competitive reasons. This may result in vague disclosures. We believe that a list of the minimum issues related to financial risk management objectives and strategies should be included in the standard so that entities develop their disclosures and comparability can be achieved among same industry participants as to their risk appetite and aversion, risk governance, and relevant risk metrics used to evidence how these entities survived in turbulent times. For instance, the risk components that are being covered should be clearly defined in the strategies. We believe that this should be included in the Implementation Guidance of the standard.

On March 3 we met with the analysts of the Mexican Stockbrokers Association, in which we used the presentation for “users” prepared by the IASB. The analysts were very supportive of the proposal that the first step to qualify for hedge accounting be that all hedging align with the established risk management objectives and strategies and that these be properly disclosed.

The analysts emphasized that assigning management the responsibility of clearly establishing the risk management objectives and strategies, not only as a basis to qualify for hedge accounting, but also for disclosing to third parties the objectives they pursue and the strategies they will use to accomplish such objectives is a significant step forward, since it will clearly indicate to all users of financial information the direction in which the entity is headed. Providing complete risk management information will improve an entity’s credit ratings while inadequate information will adversely affect such ratings.

The analysts also indicated that aligning hedge accounting with established risk management objectives and strategies will avoid presenting as hedging a transaction that is in substance speculation. Also, when an entity establishes its objectives and strategies to qualify for hedge accounting it will have to indicate the parameters it will use to measure effectiveness. If the parameters are too broad, the entity’s ratings could be penalized.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

Yes, we agree 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. However, we are not sure in the case of non-derivative financial *liabilities*, where the own entity credit risk changes are to be carried through OCI, if this particular risk factor (which never impacts earnings) might be excluded from the hedge relationship when this non-financial liability is designated as a hedging instrument.

Comment from Mexican entity:

The use of the term “non-derivative financial asset” appears confusing as it opens the door to using, among others, commodity contracts to cover some exposures. As a result, we suggest being more explicit regarding the required characteristics of non-derivative financial assets and liabilities to be met to qualify as hedging instruments.

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

Yes, we believe that designating aggregate exposures as hedged items does add flexibility to the permissible hedging scheme. This is going to be very helpful as many Mexican entities obtain financing in strong currencies based on a benchmark interest rate (i.e. LIBOR), and they prefer to hedge the aggregate exposure – e.g. loans swapped into Mexican pesos at either a floating or fixed interest rate - but later decide

to consider this *synthetic* aggregated exposure as a new hedged item to be transformed in a subsequent hedging relationship.

Nevertheless, we suggest that the ED's narrative be expanded as to orient the reader on identifying that the aggregated exposure's final profile, which might now be subject to a new hedging relationship, will be the *synthetic position* resulting from the ongoing hedge relationship which, under either of the hedge accounting models (Fair Value and Cash Flow Hedges) will be reflected within OCI. It will be also helpful to address those cases with guidance, where *basis swaps* are used as hedging instruments or within aggregated exposures.

Therefore, we believe that the standard should require ample disclosure of all hedged aggregated exposures, in such a way that the reader be able to understand how the aggregated exposure is hedged and how such hedging is in line with established risk management objectives and strategies. We believe that examples of disclosures should be included in the Implementation Guidance. We also believe that the effects of aggregated hedging instruments should be disclosed separately in OCI.

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?

Yes, we agree. This will help to solve or mitigate the problems arising in question 3, as each component has to be separately identifiable, especially for non-financial items. The risk component that is being covered should be precisely defined, which may require indicating which components are not covered.

In the case of financial assets and liabilities, we recommend additional explanation and examples regarding the eligibility and feasibility of hedging prepayment risk with derivatives or, if possible, with non-derivatives.

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?

Yes, we agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item. We also 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 because a prepayment would simply remove the hedged item, hence the hedged relationship, unless there is another option inverse to the first one within the hedge instrument that emulates the hedged item's optionality. However, we understand this would be very difficult and complicated in practice.

We believe that an example that would emphasize how difficult it would be to follow such an accounting treatment would be advisable to better understand why a prepayment option should not be eligible as a hedged item.

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 believe that the hedge effectiveness requirements, requiring that a hedge relationship be based on established financial risk management objectives and strategies and that at inception of the hedge, the hedging relationship be neutral, without a biased over or under hedging, represent adequate hedge effectiveness criterion.

The fact that in each subsequent period the penalty will be that ineffectiveness will affect profit and loss, will ensure that the risk managers in charge of setting up the hedging relationship gauge adequately the neutrality of the hedge and the prospects that the hedge will continue to be effective. Otherwise, their hedging strategy would be questioned.

Some members of our Financial Instruments Committee believe that a range to consider that effectiveness is still valid should be provided in the Standard, similar to the old 80 to 125% range. Other members believe that each entity should establish the range that, according to its objectives and strategies, is the one they must maintain before having to rebalance the hedging, and that disclosure of the range should be mandated as part of the risk management objectives and strategies.

Comment from Mexican entity:

It is not clear how derivative ineffectiveness is to be measured. In general, the phrase "to ensure that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness" appears confusing, which could diminish the benefits of the new standard.

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?

Yes, we 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 and that documentation of the rebalancing is contemporaneously prepared as part of the hedging relationship.

As previously indicated, some members of our Financial Instruments Committee recommend that guidelines on the proportion of ineffectiveness to trigger required

rebalancing should be included in the standard or in the Implementation Guidance, while other believe that the range should simply be stated in the risk management objectives and strategies.

We agree that an entity should be allowed to proactively rebalance the hedge relationship if it expects that a designated hedging relationship might fail (on a prospective basis) to meet the objective of the hedge effectiveness assessment in the future, as long as the criteria for such proactive rebalancing are clearly specified. In this regard, we believe that the criteria for rebalancing included in Appendix B is so important that it should be part of the standard, in order to include in the same section all the requirements and criteria needed for a full understanding.

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?

Yes, we 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). We would also like to see more clarity on what portion or percentage of a hedging relationship must cease to meet the qualifying criteria to trigger the discontinuance of hedge accounting, and also if multiple rebalancing is permissible, even though this might be indicative of a weak, hard-to-sustain hedging relationship since its formal designation.

We also 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. In this regard, we would like to see more clarity on how often the risk management objective and strategy may be changed and how to disclose the changes. We suggest that a formal risk governance directive by a board committee and not the trader's or treasurer's discretion be the support needed to sustain that either a change or replacement of the original risk management objective and/or strategy has been approved.

Once formally defined through a formal risk management governance process, a risk objective and/or a generic risk strategy, including risk limits, stop loss triggers, etc., should be reviewed and changed on an annual basis, but not too often, except for financial institutions dealing with intensive financial risk management activity and exposures. Changes in terms of risk limits or hedging horizon should be disclosed for comparative purposes as well, since they communicate how an entity has evolved as to its risk appetite and how this impacts its financial risk management process.

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?

Yes, we agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognized in OCI, with the ineffective portion of the gain or loss transferred to profit or loss.

We 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, as this will give transparency to the effects of hedge accounting in the balance sheet.

We believe that there should be disclosure of the amounts recognized in OCI and in profit or loss for each type of hedging strategy.

We agree that a linked presentation should not be allowed for fair value hedges as there is no right to offset the hedged item with the hedging instrument.

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?

Yes, we agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in OCI should be reclassified in accordance with the general requirements if the hedge is perfectly effective.

We also 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 OCI to profit or loss on a rational basis, in accordance with the valuation following the business model. However, we suggest providing additional guidance as to what is meant by "rational basis"; this could be explained by including an example within the Implementation Guidance.

Finally, we 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 as long as the covered risk is properly aligned with the time. Therefore, it would be useful to establish strict *critical terms match* criteria, in terms of for example, not allowing the use of an option that

covers a period when the hedged item's designated risk exposure presents a risk profile that can only be matched or offset by means of a fixed date option.

We also suggest - although perhaps reiterative - confirming that current criteria under IAS 39 used in the case of *option combinations* designated as hedging instruments, will prevail where hedged items are under either transaction or period based situations as to be allowed into one or more hedging relationships under permissible hedge accounting models.

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?

Yes, we agree with the criteria for the eligibility of groups of items as a hedged item.

Comment from Mexican entity:

In the case of our group, it is common that derivatives are contracted to hedge the residual risk exposure of a group or "basket" of risks, rather than to cover them individually. Although this item appears quite useful and valuable, many entities could improve their use of derivative instruments and, as a result, their accounting recognition if it were unnecessary to individually identify all risk elements. It would be very beneficial to be able to hedge an overall risk element.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

Yes, we agree. Otherwise, it would be impossible to determine the magnitude of the effects on each item. Presenting the effect of the hedging in separate line items will help to gauge the effect of the hedge in these situations.

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) Yes, we agree with the proposed disclosure requirements, although we believe the detail in the required disclosures is repetitive and that excessive and repetitive information may obscure the main elements to be disclosed. One of the main objectives of the disclosures is to gauge the quality of risk management, which we believe can be done with less and more focused disclosure. In this regard, we would like to see a link between the risk management decisions and resulting effects, and how such decisions that were implemented align with established risk management objectives and strategies.

b) We would recommend disclosures associated with aggregated exposures being hedged. Also, the ED mentions in paragraphs 49-52 that a tabular format should be used to meet the disclosure requirements. We suggest that the examples included in the Basis for Conclusions be included in the Implementation Guidance.

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 eligibility of such transactions for hedge accounting. We also believe that this guidance should be included in the final standard and not be included (as it is now) solely in the Basis for Conclusions. We also noted that this may require a revision of the standard for inventories (IAS 2). The latter is important when the hedged item is, or later becomes, a recognized non-financial asset, since we noted that IAS 2 is silent as to those situations where *basis adjustments* due to foreign exchange risk, price formula identified risk or the implicit price risk component (that is allowing *basis risk* exclusion under this ED) affect the inventory's carrying value at either initial recognition or during subsequent measurement, and how fair value hedge effects attributable to one or more risk factors once these non-financial hedge item (inventory) offset the *lower of cost or market* adverse effect on the inventory's carrying value through earnings (cost of goods sold) under IAS 2.

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?

Yes, we agree that all three alternative accounting treatments to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments, but since these type of derivatives are targeted at allowing credit risk within financial assets to be transferred to parties with an appetite for such risk, we believe their suitability as hedging instruments should be reconsidered once the impairment section of the IFRS 9 standard is completed, as to identify both where the sources of risk and how those risk factors identified within financial assets translate into adverse impairment effects within earnings, to determine the suitability of these credit derivatives as hedging instruments.

Additionally, although financial guarantees and credit insurance instruments do not meet the definition of a derivative, it would be worthwhile to explore its appropriateness from a hedge accounting perspective. Since we are now allowing non-derivative financial assets or liabilities to be used for hedging purposes, we should explore how these non-derivative instruments might be suitable to be allowed as hedging instruments for credit risk exposures under the entity's risk objective and strategy.

Question 16

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

Yes, we agree with the proposed transition requirements that indicate the new hedge accounting rules should be applied prospectively.

Should you require additional information on our comments listed above, please contact Juan M. Gras at (52) 55 5596 5633 ext. 105, William Biese at ext 113 or me at ext. 103 or by e-mail at jgras@cinif.org.mx, wbiese@cinif.org.mx, or fperezcervantes@cinif.org.mx, respectively.

Sincerely,

C.P.C. Felipe Perez Cervantes
President of the Mexican Financial Reporting Standards Board
Consejo Mexicano para la Investigacion y Desarrollo
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