



## **BASEL COMMITTEE ON BANKING SUPERVISION**

**BANK FOR INTERNATIONAL SETTLEMENTS**

Chairman

Email: [Commentletters@ifrs.org](mailto:Commentletters@ifrs.org)

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

16 March 2011

### **Hedge Accounting**

Dear Sir David

The Committee welcomes the opportunity to comment on the IASB's Hedge Accounting Exposure Draft (ED). The Committee has a strong interest in high quality financial reporting by banking organisations. We encourage both the IASB and the FASB to continue developing a single set of high quality accounting requirements that would be beneficial to supervisors, investors and other users across the globe. Our interest is particularly heightened given the April 2009 call by the G20 Leaders for "accounting standard setters to work urgently with supervisors to [...] achieve a single set of high-quality global accounting standards"<sup>1</sup> as an action to strengthen financial supervision and regulation.

Accounting information presented in banking organisations' financial reports is generally the starting point for evaluating the condition, performance and risk profile of individual financial institutions at supervisory authorities. Accounting information also serves as the foundation for critical prudential ratios, such as minimum requirements for capital, leverage, and liquidity as well as investment and transaction limits. Our careful consideration of this has been driven by the potential impact of several expected International Financial Reporting Standards (IFRS) on the comprehensive set of supervisory reform measures known as Basel III, which were developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision and risk management of the banking sector and will be implemented in phases between 2013 and 2018.<sup>2</sup> The standard

---

<sup>1</sup> G20 Communiqué, Declaration on strengthening the financial system, London, 2 April 2009.

<sup>2</sup> The measures aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance; and strengthen banks' transparency and disclosures. The reforms target bank-level or microprudential regulation, which will help raise the resilience of individual banking institutions to periods of stress; and macroprudential system-wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time. These two approaches to supervision are complementary as greater resilience at the individual bank level reduces the risk of system-wide shocks. Additional information about implementation is included in the Appendix (see Question 3) with complete details on Basel III available from the Bank for International Settlements website: [www.bis.org](http://www.bis.org).

on financial instruments, in particular, is likely to have the greatest impact on bank balance sheets and the Basel III reform measures presently underway.

We support the IASB's efforts to undertake a comprehensive review of the existing hedge accounting requirements in IAS 39. The new requirements look to facilitate alignment of accounting and risk management practices.<sup>3</sup> This is a welcome development. The Committee is supportive of a closer alignment between risk management policies and practices and hedge accounting. Specifically, we would recommend that this ED contain an explicit requirement that aligns the qualification criteria for hedge accounting with clearly defined and sound risk management policies and activities that form part of an entity's risk management framework.

The Committee expects financial institutions to engage in sound risk management practices. Also, as we have noted previously in our comment letters, we support simplifying hedge accounting requirements and moving to a more qualitative approach for hedging. We recognise that this ED introduces several new concepts (eg with "rebalancing", "other than accidental offsetting") into the accounting literature that are intended to enable a tighter linkage with existing risk management. However, we also recognise the need to maintain rigor when moving to a more qualitative approach.<sup>4</sup> We also understand the sentiments expressed in the ED's alternative views that some notions such as effectiveness testing<sup>5</sup> are not clearly and consistently defined and explained in the ED and may lead to unintended consequences. In order to ensure that these requirements operate as intended and are consistently applied in practice, we would recommend that these notions be further clarified before the standard is finalised.

We also note that the ED does not address open portfolios or macro-hedging. We are unclear from this ED how certain proposals (eg prepayment options) will interact with the IASB decisions regarding macro-hedging of portfolios for interest rate risk.<sup>6</sup> This makes it difficult to assess the overall applicability of these proposals to banks without the macro-hedging proposals. We encourage the IASB to continue working on these aspects of hedging in order to ensure sound

---

<sup>3</sup> Refer to the BCBS comment letter on the Discussion paper – Reducing complexity in reporting financial instruments (September 2008).

<sup>4</sup> The Committee's response to the 2008 Discussion Paper *Reducing complexity in reporting financial instruments* noted that "while we encourage the IASB to look for ways to **simplify the existing requirements**, we agree with the standard setters' long held view that **discipline is required in this area**, given the scope for revenue and earnings to be made less transparent and the risk of abuse. That said, there is a **need to balance the risks of non-hedging relationships being portrayed as hedges by preparers against the risk that overly tight requirements could prevent genuine hedges from being treated as such for accounting purposes**" (emphasis added).

<sup>5</sup> The Committee is supportive of removing the bright lines with effectiveness testing. However, there is still a need to ensure that the principles in the ED are clear, and can be consistently applied in practice.

<sup>6</sup> The prohibition of designating a layer component of a contract that includes a prepayment option and the decision to maintain the restriction in IAS 39 regarding the designation of risk components when the designated component would exceed the total cash flows of the hedged item, ie sub-libor issue will prevent banks from reporting properly in their financial statements their actual interest rate risk management activities, which are strategic for them.

economic hedging relationships undertaken as part of a bank's risk management activities can be addressed.

We would recommend that the new requirements be clearly and consistently defined and explained, and be introduced in a measured way to enable convergence of hedge accounting requirements and ensure a level playing field across the globe. This approach would allow consideration of the hedge accounting requirements more holistically with the other phases of the IFRS 9 project, including macro-hedging and the treatment of open portfolios, and would mitigate against unintended consequences. To that end, we would recommend a post implementation review of this standard to ensure that any unintended consequences are addressed. We also make some suggestions in our responses to the specific comments to this ED to address/mitigate some of the concerns expressed in the alternative views.

Our responses to some of the specific questions outlined in the Request for Views are set out in Appendix A below. We trust you find these comments helpful.

---

These comments have been prepared by several groups within the Committee that are chaired or co-chaired by Sylvie Mathérat, Deputy Director General at the Banque of France, and Jerry Edwards, Senior Advisor, Basel Committee Accounting Task Force. If you have any questions regarding our comments, please feel free to contact Sylvie Mathérat (+33 1 4292 6579), Jerry Edwards, (+41 61 280 8055), or Rob Sharma at the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely



Nout Wellink

**Cc:** Ms Leslie F Seidman, Chair, FASB

# Appendix A

## Responses to specific questions

### Question 1

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

We agree that financial statements should represent the economic effects of an entity's risk management activities. We are generally supportive of the more principles-based approach for hedge accounting proposed in the ED, because such an approach would bring hedge accounting more closely into line with risk management practices. As a result, the economic effects of hedging transactions should be reflected more appropriately in the financial statements than under the current IAS 39 hedge accounting requirements.

However, we believe that it is important to include appropriate safeguards to maintain rigor in accounting application, to prevent the link between hedging activities and their reflection in the financial statements being used improperly, for example, to manage earnings or to inappropriately defer loss recognition. To achieve this, the objective of hedge accounting should be to reflect risk management activities aimed at offsetting<sup>7</sup> the impact of risk exposures in profit or loss or other Comprehensive Income (OCI). This reduces the risk of the proposal being interpreted as providing "free choice" in the measurement attribute of assets and liabilities and safeguards against inconsistent accounting practices.

### ***Treatment of Instruments in Fair Value through Other Comprehensive Income<sup>8</sup> (Strategic Equity Investments)***

The ED prohibits hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income (OCI). However, one of the goals of this ED is to improve hedge accounting by aligning it more closely with the reporting entities' risk management and hence producing more useful information (IN3(a)). In this vein, we believe that hedge accounting for financial instruments at fair value through OCI should be permitted. This acknowledges that entities may have valid hedging strategies for risks inherent in positions accounted for in OCI.

---

<sup>7</sup> Offsetting is used in its broadest sense above. This is not as outlined in the offsetting ED or the Basel leverage ratio project.

<sup>8</sup> This terminology is consistent with the FASB tentative direction of Jan 25, 2011 on the Classification and Measurement of Financial 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?

**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?

The Committee recognises these aspects are important issues for banks. However, the Committee would like to reserve its feedback on these aspects of the proposal (and on prepayment options) until the IASB issues for public comment the second phase of its hedging project which is the macro-hedging part of its hedging proposal. In the Committee's view, these aspects are closely related to the macro-hedging part of the proposal, and these matters need to be considered holistically.

**Question 4**

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We agree that institutions should be allowed to designate risk components as hedged items, provided that they are separately identifiable and reliably measurable. We further agree that the determination of appropriate risk components requires an evaluation of the relevant facts and circumstances. We note that the proposal is quite prescriptive in analysing some risk components (eg, inflation and credit risk), while offering relatively little guidance for non-contractually specified risks, for which there is arguably a greater potential for manipulation. We recommend that the IASB further clarify its intent in this area.

**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 agree that institutions should be allowed to designate a layer of a nominal amount as the hedged item. Such practices are consistent with prevailing risk management activities. However, we believe that further clarity is needed in this area. For example, it is not clear what is meant by the term *bottom layer* in paragraph 36 of the proposal. It is also not clear whether the proposal would maintain the discipline in IAS 39 regarding the identification of forecast transactions (ie, the requirement to document a hedged forecasted transaction with sufficient specificity such that the hedged item can be clearly identified when the cash flows

are received or expended). We believe that appropriate safeguards in this area are warranted to protect against potential abuses associated with “cherry picking” hedged transactions after they occur (eg, to minimise measured ineffectiveness).

We also note that the prohibition with respect to prepayment options presumes that prepayment risk and interest rate risk cannot be separately identified and measured.<sup>9</sup> However, banking entities often have modelling techniques for prepayment risk for certain instruments that may be reliable for incorporation into fair value estimates. We would ask the IASB to reconsider whether a blanket rule prohibiting all prepayment options is necessary, within an otherwise principles-based standard.

#### **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?

The IASB’s proposal introduces an objectives-based approach to the qualifying criteria for hedge accounting. Conceptually, we prefer such an approach over the current arbitrary 80 to 125 per cent bright line rule, because it enables companies to better reflect risk management policies in their accounting than under the current model and avoids the overly punitive consequences of ‘failing’ the effectiveness test. The Committee is supportive of a closer alignment to risk management policies and activities and we note that the ED does not contain an explicit requirement for this alignment in order to qualify for hedge accounting. Specifically, we would recommend that this ED contain an explicit requirement that aligns the qualification criteria for hedge accounting with clearly defined and sound risk management policies and activities within a bank’s risk management framework. Such a requirement would help to ensure that the hedge accounting treatment better reflects economic reality.

The hedge effectiveness requirements expect hedging relationships to meet the objective of hedge effectiveness assessment and to achieve other than accidental offsetting. Paragraph B29 of the application guidance to the draft standard introduces as the objective of hedge effectiveness assessment that the hedging relationship will produce an “unbiased” result and “minimise expected hedge ineffectiveness”, without adequately explaining what “minimise expected ineffectiveness” means in practice. We believe that an objective in terms of “minimising expected ineffectiveness” could be confusing because it could be interpreted in the same way as the current ‘highly effective’ requirement in IAS 39.88. To remove such potential confusion, we believe the standard should provide a better articulation of the “unbiased result” and “minimise expected hedge ineffectiveness” concepts.

From the discussion in paragraph BC80-81, it appears that the IASB originally intended to have only “other than accidental offsetting” as hedge effectiveness criterion but later added “unbiased result” and “minimise expected ineffectiveness” as criteria to prevent inappropriate hedging relationships. Given the significance of these criteria for assessing hedge effectiveness, we also recommend that the IASB include these criteria in the standard – ie paragraph 19(c) – rather than in the application guidance.

We also note that the second condition for hedge effectiveness is for hedges to achieve “other than accidental offsetting”. We believe this principle needs to be drafted in a *positive* form. The positive form should ensure that *a statistically meaningful and valid economic relationship is maintained between the hedged item and the hedged instrument*. As currently

---

<sup>9</sup> Refer paragraph BC 69.

drafted it may be too broad and may allow more hedging relationships to qualify for hedge accounting than the IASB *intended*. We believe a more robust and explicit linkage with clearly defined and prudent risk management policies and activities that form part of a bank's risk management framework would result in a more rigorous hedge effectiveness requirement.

#### 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 support the concept of “rebalancing” hedging relationships, because it enables an entity to reflect in its hedge accounting the changes in hedge ratio that it makes for risk management purposes. We believe it would be important for an institution to document the “rebalancing” relationship in accordance with its clearly defined and sound risk management policies and activities. This would potentially avoid manipulation by “managing” the threshold for rebalancing (ie the entity’s determination of when the hedge becomes ineffective). In this way, as hedges are often “dynamic”, the “rebalancing” is more likely to reflect the actual risk management practice without cumbersome and artificial de-designation and re-designation in those cases where the risk management remains unchanged.

Keeping in mind these concerns, the Committee also considers it important that the standard states clearly how economic effects of “rebalancing” are recognised in the financial statements. In particular, the concept that “*on rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised in profit or loss immediately before adjusting the hedging relationship*” (para B47) should be upgraded to the main text of the standard.

#### 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?

Overall, the IASB’s proposal on discontinuation of hedge accounting is in line with the ED’s objective of having a better link between an entity’s risk management strategy and its accounting. 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. Furthermore, we also believe that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy, and that continues to meet the qualifying criteria.

In view of the above, we believe that a hedge accounting standard where reliance is placed on an entity's risk management should include a requirement for an entity discontinuing hedge accounting (due to a change in risk management objectives) to provide a disclosure about that particular risk management policy change.

#### **Question 9**

- (a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?
- (c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

We agree with the IASB's proposal to recognise the gain or loss on the hedging instrument and the hedged item in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss as it simplifies existing requirements and provides greater transparency and comparability.<sup>10</sup>

While we recognise the shortcomings of the existing measurement basis the proposed approach represents a potential expansion of financial statement line items on the face of the balance sheet that may detract from the usefulness of presentation.

Therefore, we would recommend combining the hedged item and the hedging gains and losses on hedged items on the balance sheet for different classes of financial instruments.<sup>11</sup> This would reduce the number of line items on the face of the balance sheet relating to hedging gains and losses on hedged items. The detailed breakdown of the hedging gains and losses could be provided in the notes to the financial statements. The Committee believes this requirement should be complemented by a rigorous internal control and risk management framework.

While linked presentation would provide information about the existence of a relationship between an asset and liability, such presentation does not enable the user to see the nature of the relationship, ie the risk or risks that are linked. Therefore, we agree with the IASB that

---

<sup>10</sup> An issue may arise with postponing amortization of the separate line item (paragraph 28 of the ED), since this postponement would allow interpreting as hedge ineffectiveness the profit or loss impact that represents the lack of amortization of the separate line item (accumulated hedge adjustments). A balance could be reached between conveying a transparent picture of the profit or loss impact (by amortizing from the very moment when a fair value adjustment takes place) and the need to recalculate the effective interest rate. This balance could be achieved through the disclosure of both the amount of amortisation of the accumulated hedge adjustments and the amount of ineffectiveness.

<sup>11</sup> Classes of financial instruments and financial and non-financial items can also be distinguished under this approach.



linked presentation should not be allowed as we believe that it would increase rather than decrease confusion for users of an entity's financial statements.

**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?

We agree with (a), (b) and (c) above. It makes sense to view the "time value" as a cost of hedging, impacting the profit or loss accordingly. However, we have some concerns about how entities may be able to comply with these requirements in practice and about the impact on financial statements comparability.

We question whether the current IAS 39 approach (fair valuing the option's time value through profit or loss) and the ED proposal (amortising to profit or loss on a rational basis) will substantially differ in all practical situations, bearing in mind that by definition the time value of an option is subject to *time decay*. Given the potential operational complexity of the proposed approach, we would invite the IASB to investigate how an entity could apply these requirements reliably and properly and whether there is existing practice in this area.

**Question 12**

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

We agree with the separate line item presentation in the income statement as this better explains to users the impact of hedging of the net position and prevents distortion of the income statement.

**Question 13**

- (a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?
- (b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

We agree with these disclosure requirements but propose additional disclosures with respect to how management defines “unbiased result” and “minimise hedge ineffectiveness” to aid understanding of how the entity applied these terms to their hedging strategies. We note also that these disclosure requirements are consistent with the FASB’s. However FASB also requires derivatives not designated as hedging instruments to disclose the same information and we would encourage both the IASB and FASB to reconcile this difference. Also please refer to our disclosure recommendation in Question 8.

**Question 16**

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

We welcome the IASB’s proposal to adopt the proposed hedge accounting requirements on a prospective basis. This is because the hedge accounting requirements introduce a more forward looking hedge effectiveness testing concept, and therefore hedging transactions can only be designated prospectively.