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

11th March 2011

Dear Sir David,

IBFed Answer the ED Hedge Accounting

The IBFed is the representative body for national and international banking federations from leading financial nations around the world. Its membership includes the American Bankers Association, the Australian Bankers' Association, the Canadian Bankers Association, the China Banking Association, the European Banking Federation, Indian Banks' Association, the Japanese Bankers' Association, the Korean Federation of Banks and the Bankers' Association of South Africa. This worldwide reach enables the Federation to function as the key international forum for addressing legislative, regulatory and other issues of interest to the global banking industry.

The IBFed fully supports the review of the current hedge accounting rules in order to reflect in the financial statements institutions' risk management activities in more faithful way. However, at this point in time, the IBFed does not have all the elements that would enable it to fully validate the proposal; whilst the ED largely focuses on hedge accounting issues for non-bank corporations in the context of one-to-one hedging relationships, banks operate open macro hedging portfolios that are outside the scope of this ED. The IBFed therefore looks forward to the opportunity of making a final assessment of the whole revision of hedge accounting rules when they will include portfolio hedging.

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

However, we believe that there are a number of areas where the proposals should be improved. We would like in particular to emphasize the following issues:

- The ED stands aside from addressing issues concerning the hedging of debt instruments with negative indexation (the 'sub-LIBOR issue'). As resolving the issues concerning this are central to enabling hedge accounting to align to risk management practice, including the identification of core deposits as the hedged item for the purpose of hedging interest rate risk, we underline the importance of resolving this issue as part of the proposed requirements for portfolio hedging which the board envisages exposing later this year. This remains a major gap in the IASB's hedge accounting proposition and needs to be addressed.
- The exception set by paragraph B 23 to the bottom layer approach for instruments with prepayment options: to be near the bottom layer is precisely the purpose of under hedging strategies implemented by banks to address the issue of prepayment risk. So, it is inconsistent to recognize that these strategies are well grounded and to exclude them in the precise circumstances where they are implemented.
- The non-acknowledgement of internal contracts and prohibition of de-designation when internal contracts are not recognized; should internal derivatives continue to remain "out of scope" in the final standard: It is imperative that an entity have the ability to de-designate voluntarily, as it is the only practical way to comply with documentation requirements for dynamic hedging strategies.
- The prohibition of hedging credit risk: credit risk management is crucial for the banking industry and hedging that risk with derivatives is a very common practice for mitigating credit exposures. The opinion expressed in the Basis for Conclusions (BC) is rule-based and therefore not in the spirit of a principle-based approach to setting accounting standards. Credit Default Swaps (CDS) are effective tools for transferring that risk to counterparts and, properly used, achieve other than accidental offsetting between the asset held and the derivative in the event of default. We acknowledge that there are some issues to be dealt with, notably those linked to CDS fair value changes due to factors other than the credit rating of the obligor. Nevertheless, solutions to these obstacles can be found so that we can recognize in the financial statements a basic risk management strategy.

It must be highlighted that various rules newly included in the ED or maintained from existing IAS 39, such as those listed above, prohibit the use of risk management strategies to justify many hedging transactions. These constraints will lead institutions to renew their current practice of artificially designating hedged items not related to the risk management strategy, only to fulfill accounting requirements. In such circumstances, the corresponding disclosures will often be meaningless as some sources of risk, effectively and actively managed by financial institutions, including core deposits, will remain ineligible for hedge accounting.

In addition, more clarity should be provided *inter alia* regarding:

- The concept of “unbiased” result produced by a hedge relationship
- The scope of rebalancing (*versus* de-designation/re-designation)

Narrowly interpreted, the proposed wording introducing these two concepts can lead to the conclusion that the standard requires permanent adjustment of the hedging instruments in order to achieve 100% effectiveness ex ante, which does not seem to be the Board's initial intention.

All these topics are very technical in a banking context and our members will welcome any opportunity to help the Board in designing principles that increase the understanding of stakeholders of risk management activities and to provide advice on what can be implemented from an operational perspective.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Sally J Scutt'. The signature is fluid and cursive, with the first name 'Sally' and last name 'Scutt' clearly distinguishable.

Sally J Scutt
Managing Director

A handwritten signature in black ink, appearing to read 'Mike Domann'. The signature is fluid and cursive, with the first name 'Mike' and last name 'Domann' clearly distinguishable.

Mike Domann
Chair, IBFed Accounting Working Group