

# POSITION PAPER



## **ESBG position paper on general hedge accounting**

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ESBG Register ID 8765978796-80

**09 March 2010**



## 1. Introduction

ESBG considers that the general hedge accounting model proposed in the exposure draft (ED) provides a number of significant improvements that will improve hedge accounting rules.

ESBG also highlights how important hedge accounting is for savings and retail banks: the revenue of banks comes from the collection of contractual cash flows over time from financial instruments that are held in the balance sheet (customer loans and deposits, interbank lending and various Asset and Liability Management financial instruments). Banks' income does not result from the absolute levels of interest on loans and on funding, but rather from the difference between them. This difference is not always constant, as it is impacted by the various commercial rates granted on both sides and by maturity mismatches between assets and liabilities. This is when risk management sets in. It consists of reducing the variability of the margin due to the mismatches by entering into hedging transactions which offset part or all of the mismatches.

The risks for which application of hedge accounting risk is relevant are almost exclusively found in the banking book. The banking book contains non-speculative financial instruments which nevertheless carry risks (such as interest rate risk and prepayment risk) which need to be hedged. These financial instruments are generally not measured at fair value through Profit or Loss (P&L) and therefore a hedge accounting mechanism is necessary to show the offsetting effects between hedged risks and hedging instruments.

Asset and Liability managers manage the risks incurred by the bank with respect to its activity as an intermediary between economic agents that have different needs and risk appetites. This allows for the transformation of short term resources into long term uses. The purpose of hedging is not to manage the fair value exposure of the asset or liability but to achieve a target interest margin. It is vital for savings and retail banks.

It is against this background - and in front of a regulatory tsunami - that it is of utmost importance not to change the way banks operate and fund the economy. This is true whatever the funding model of the economy is, a European one with the importance of banking intermediation or an American one with the importance of capital markets as a source of funding.

ESBG is therefore extremely satisfied that the IASB agrees with the direction of the pro-active paper savings and retail banks sent in January 2010 to the IASB which argued that the objective of hedge accounting is to reflect, in the financial reporting, the extent and effects of the entity's risk management activities. Accounting should appropriately reproduce the economic reality. Similarly we welcome the principle-based approach taken. A principle-based approach is more robust and responsive to developments of the economy, to the creation of new products and to the various hedging strategies that exist in all their diversity.



In this regard ESBG welcomes the proposals to remove a number of important restrictions to hedge accounting that exist in IAS 39. We appreciate the simplifications in the area of testing hedge effectiveness and the introduction of the time value of the options for the hedges.

However ESBG has some concerns, some of them are linked to present proposal other are linked to macro hedge accounting.

**1. Some clarifications are needed.**

First of all there are some complexities which need to be addressed, in particular in the rebalancing of hedge relationships. Furthermore allowing only closed portfolio hedges in paragraph 7 of the Introduction (IN7<sup>1</sup>) is in direct contradiction to some parts of the ED which requires that hedged items or hedging instruments are adjusted during the hedges. Similarly the treatment of time value of options needs further clarifications.

**2. There is a risk of undue volatility.**

Secondly we stress that it is unfortunate that the new principle based model does not avoid undue volatility in Profit & Loss (P&L) or in the Other Comprehensive Income category.

**3. Additional eligible items are needed.**

Furthermore we regret some restrictions regarding eligible hedging instruments and eligible risk components as hedged items. We consider that sub-Libor components should be eligible to hedge accounting as well as some other risks such as inflation or credit risk.

**4. Lack of full Picture is deeply regrettable.**

Lastly ESBG regrets not to be able to have an idea of what the new hedge accounting rules, in their entirety, will look like. We are still missing a proposal on macro hedge accounting. The revision of IAS 39 consists in a number of phases that are interdependent. We are not able to comment more fully on the proposals relating to groups of items until we gain a better understanding of the IASB's direction in respect of macro hedging.

Given the importance of macro hedging, we believe that the IASB should not finalise a standard on the general hedge accounting model, before developing a model for macro hedging. While we can understand the need to consult on general hedge accounting first ESBG does not understand why there is a need to publish a general hedge accounting model before a macro hedge accounting model. A single publication encompassing both a general hedge and a macro hedge accounting model should be the solution, as asked by European stakeholders.

One of the reasons advocated by the IASB for the two-step approach is that there is a need from industries and services for a general hedge accounting model. We do agree with the IASB but at the same time we do not understand why this need, which also exists for financial services, has not been similarly considered. Furthermore the revision of IAS 39 finds its roots in the financial crisis and it renders the need for transparency of utmost importance for banks and other financial institutions.

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<sup>1</sup> Quote: *The Board considered hedge accounting only in the context of groups of items that constitute a gross position or a net position in closed portfolios (in which hedged items and hedging instruments can be added or removed by de-designating and redesignating the hedging relationship). The Board is continuing to discuss proposals for hedge accounting for open portfolios.*



## **5. Allowing hedge accounting for contracts with prepayment options**

The prohibition from designating as hedged item a layer component of a contract that includes a prepayment option raises an important concern regarding its implication on macro hedging. The fact that prepayment risk may not be designated as the risk being hedged for a financial asset is in contradiction with the IASB's objectives which is hedge accounting has to reflect, in the financial reporting, the extent and effects of the entity's risk management activities. In addition we do not consider that the arguments for such a prohibition are very well substantiated. At the minimum we would like the IASB take this concern into account with its macro hedging proposals when they are published.

## **6. Macro hedging and the move towards global standards**

In October 2002, the FASB and the IASB announced the issuance of a memorandum of understanding ("Norwalk Agreement"), showing their commitment to the convergence of U.S. and IFRSs. The G-20 set the deadline for convergence at the end of 2011.

ESBG understands that the next 10 months will be critical in determining whether the goal of a "single set of high quality global standards" will be realized. Against the G-20 deadline, the IASB and the FASB have done much to reduce difficulties and costs by narrowing the differences between the two systems in their convergence projects.

ESBG also knows that a negative decision on IFRS in 2011 by the SEC - or, as bad, a decision to delay an adoption commitment - would likely have important consequences. In such circumstances, two worst case scenarios are probable:

- First, the coalition of nations supporting IFRS could break apart. Rather than two sets of accounting standards, IFRS and U.S. GAAP, we could go back to pre-2000 fragmentation. Many national accounting systems would exist. The cost, in terms of lack of transparency and comparability, higher accounting expenses, etc., would be extremely large.
- The second basic scenario is worse from a U.S. perspective. The coalition in support of IFRS could hold and the U.S., home of the largest and deepest capital markets in the world, would become isolated. The U.S. would no longer play the large and constructive role it now plays in IFRS development and oversight.

Confronted with these two scenarios the IASB faces today two choices. Either it chooses to go for convergence at all costs and takes the risk of criticism from non-U.S stakeholders or it decides to secure confidence from its major stakeholders, i.e. the European Union, and obtains major support for convergence. ESBG, in accordance with the IASB has always believed that quality is key. We also welcome a global standard.

This is why, as macro hedge accounting is the major political issue from EU perspective, and as it is not in this proposal, ESBG, will recall in Annex to our answers the key messages and principles we highlighted in our pro-active paper of January 2010. Furthermore, we will include at the end of our position paper other issues which concern savings and retails in Europe and which need to be addressed. These issues are:



1. the sub-Libor issue,
2. time portions of hedging instruments and
3. determination of the present value of the change in the hedged cash flows

ESBG believes in the importance of working towards the adoption of a solution to ensure that all banks, whether European or American can implement the same hedge accounting provisions. The ED is an important step forward but we have some comments and concerns. We consider it of utmost importance to find a solution that takes into account the risk management practices applied by the banking industry.

### 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, with disagreements.

ESBG agrees with the direction of the proposed objective to reflect, in the financial reporting, the extent and effects of an entity's risk management activities.

We fully support objective of hedge accounting which is focused on representing the effects of risk management activities and which is in accordance with ESBG's pro-active paper on macro hedge accounting (see appendix).

Indeed the current accounting rules (IAS 39) raise recurring difficulties for preparers of financial statements, which prevent them from appropriately reflecting in their financial statements the economic effects of hedging transactions. Some financial instruments used for risk management purpose are currently creating volatility in profit or loss whereas they could constitute an efficient economic hedge of a specific risk exposure. Disclosure on the impact on their P&L of some economic hedge not eligible to hedge accounting or non GAAP indicators are the only alternative found by some entities in order to provide their actual hedging results, which is not satisfactory. The current IAS 39 hedge accounting rules do not allow economic offset of significant hedging activities to be reflected in the financial statements for both financial and non-financial institutions entities. This does create confusion and misunderstanding for users of financial statements.

We consider that the goal to align hedge accounting with risk management activities will avoid most of the drawbacks of IAS 39. Moreover, we consider that a principle-based approach is better than a rule-based approach, such as IAS 39 current requirements.

However ESBG disagrees with a couple of points.

#### **1. The necessity to allow hedge accounting for hedged items that only impact OCI**

- The issue: having hedge accounting only restricted to P&L is inconsistent with the prohibition of recycling.



We do not believe that hedge accounting should be only restricted to risks that affect P&L. We would have liked the IASB to better explain why it is necessary to prohibit hedge accounting for items that affect Other Comprehensive Income or equity as well.

Some exposures are, according to IFRS, only affecting equity or Other Comprehensive Income (OCI) without being recyclable in profit or loss. These exposures are real economic exposures that could affect the net asset of the entity and thus the shareholders wealth. Therefore, the ED will discourage as in the current IAS 39 entities from hedging real economic exposures or will create undue volatility in P&L.

ESBG has not found any sound reason for excluding hedge accounting for items that affect Other Comprehensive Income. The ED precludes from designating equity measured at fair value through OCI as hedged item because gain or loss is not recyclable in P&L.

First of all, we reiterate that the prohibition of recycling between OCI and P&L for equity instruments under IFRS 9 is inappropriate since it would result in a misrepresentation of entities performance in the income statement.

But more importantly ESBG stressed that by interacting with the proposed hedge accounting rules, the prohibition of recycling introduces additional issues: namely a distortion of competition and the introduction of a new tainting rule

The problem is that many entities have sound reasons to mitigate this volatility in OCI by contracting hedging instruments, and especially banks especially since they will be imposed stricter capital requirements.

This issue is further highlighted when assessing the reason for this restriction. It is merely explained by the interaction between the Phase I and the Phase III of IFRS 9 and unfortunately takes too much of a narrow minded approach. The reality is that the prohibition of recycling for investment in equity instruments designated at FVTOCI could create a distortion of competition as the entities using the FVTOCI category should be further punished because they cannot hedge their economic exposure. Prohibition of hedge accounting for these financial assets consists in an introducing a tainting rule – something which is not substantiated from conceptual point of view and that the IASB wants to suppress altogether. We admit the practical concerns of IASB mentioned in the paragraphs BC22 to 26. But they only show that prohibition of recycling for financial instruments is a rule-based measure which creates additional issues.

- The conclusion: allowing recycling in IFRS 9 Phase I or allowing hedge accounting in OCI is necessary.

Therefore ESBG urges the IASB to be consistent and keep the track of its goal which is to take into account the way risk are managed rather than switching to pure accounting reasoning which can makes it miss the goal pursued.

This why, in accordance with the European Commission and other banking associations, we ask again for amendments of IFRS 9 - Phase I. European stakeholders are generally against the prohibition of recycling<sup>2</sup>.

ESBG considers that if IFRS 9 - Phase I is maintained as such (which is fairly likely as there is intense pressure on the IASB to finish the replacement project of IAS 39 by mid-2011), it should be necessary

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<sup>2</sup> And of bifurcation



to allow hedge accounting for a hedged item that only impact OCI, and recognise symmetrically in OCI the effective part of the hedging instrument. Not doing this would be in opposition with the purpose of IFRSs which is to provide to users of financial statements faithful representation of the economic activity.

## **2. The issues caused by not allowing the use of internal derivatives**

ESBG would like to point out prohibiting the use of internal derivatives for hedge accounting introduces artificial elements when talking about actual risk management activities. In fact it is inconsistent with the way banks manage their risks.

We consider that the exposure draft, in order to be consistent, should also discuss the effects of such decisions. Banks do use an internal derivative for risk management strategies at the level of hedged item.

As already written in the introduction part, risks for which hedge accounting is relevant are almost exclusively found in the banking book. To manage the risks banking book enters into internal hedging instruments with the trading book. They take a form of derivatives (i.e. internal derivatives). Trading book aggregates risk positions from all of its external and internal deals and manages the trading risks within risk limits. Only trading book enters into external derivatives. Actions of the trading book are independent of the individual internal transactions with the banking book.

Currently hedge accounting principles require that only external transactions may be used as hedging instruments. However it is difficult to find individual external transactions which fully match internal hedging instruments because of independent actions of banking and trading book.. Risk management objective and strategy are primarily based on the relationship between the hedged risk and the internal hedging instrument. The need of designating external hedging instrument automatically deviates from the actual risk management. The adverse effects are following:

- hedging instruments have to be searched in an artificial way, which may result in a need to enter into hedging instruments in a way which is costly,
- testing of hedge effectiveness has to be performed between the hedged risk and external hedging instrument which may differ from the actual risk management strategy applied between the hedged risk and internal derivative,
- need of rebalancing may occur even when hedging relationship is unbiased from actual risk management point of view (issue is addressed in the answer to the question 7(a).

If the IASB wants to truly link the objective of hedge accounting to the risk management activities, it should take into account the differences which occur between the real risk management practice and the cost of having external hedging instruments. We do not understand the rationale in the Basis for Conclusion 43 which states that: “The Board noted that the eligibility of internal derivatives as hedging instruments is not the root cause of misalignment between risk management and hedge accounting. Instead, the challenge is how to make hedge accounting operational for group of items and net



positions”. As explained above the misalignment between hedge accounting and risk management is a serious practical issue which should be addressed properly.

We understand that it is difficult to allow using internal hedging instruments in the current environment when consolidation principles in IAS 27 require that all internal transactions are eliminated. We think that attention to this issue should be also dedicated from conceptual point of view within the phase Elements and Recognition of the Conceptual Framework project.

### **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, with a question.

By principle, we agree that hedging instruments should not be limited to derivatives instruments since entities are also using cash-instruments as hedging instruments for risk management purposes. It enables an entity to align its hedge accounting closer to its risk management objectives.

ESBG wonders if there a conceptual basis for excluding as eligible hedging instruments any non-derivative financial instruments that are not at fair value through profit or loss.

### **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.

Hedge accounting principles which are focused on risk management activities of the entities should recognise the fact that synthetic exposures comprising derivatives are eligible hedged items. Therefore we welcome the proposal. It will indeed align hedge accounting requirements with the way entities are managing in practice their risk exposure during the life of some hedged items, for instance the interest rate risk of their financial liabilities.





#### 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 (i.e. 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.

ESBG welcomes the proposal to allow the designation of a risk component as a hedged item if it is separately identifiable and measurable. We agree with the principle proposed by the ED addresses homogeneously both financial and non financial items.

- **Comments:** the necessity to introduce inflation as a possible hedged item

However, we do not see the rationale behind the IASB's decision to prohibit entities from designating as hedged item inflation component of financial instruments or the credit risk of financial instruments (see Question 15). These restrictions are adding arbitrary rules (coming from IAS 39), which seems contradictory with the principle-based approach for hedging risk components as proposed by the ED.

Inflation is an input observable in the market and thus reliably measurable. Moreover, the sensitivity of financial instrument to inflation is well identified by market participant. Therefore, we do not see the rationale leading to prohibit inflation (not contractually specified) from hedge accounting. We also wonder whether this prohibition could have unintended consequences of the qualification of risk component of non financial items.

- **Concerns:** risk components and sub-libor

We have two additional concerns about risk components which are relevant for our members but are not provided with a satisfactory solution by the ED (we discuss the credit risk component issue further in the answer to the Question 15). We have also some high concerns on the hedging of libor component of sub-libor financial instruments (see other major matters at the end of this questionnaire). We deeply regret this issue of sub-Libor component is not questioned separately in the ED even if this is a major topic which has been raised over past years by the banking industry.

#### 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?

(a) YES.

We fully support to designate a layer component of the nominal amount of hedged items. We agree that an entity should be allowed to designate a layer of the nominal amount (or volume) of an item as hedged item either in a cash flow or fair value hedge relationship. Indeed, ESBG considers that



ineffectiveness cannot result from under-hedge (i.e. designating a hedged amount below the risk exposure), when the objective is to purposely under-hedge a risk exposure (see ESBG proactive paper on macro hedge accounting in Appendix). Allowing a layer approach is an appropriate way to address such issue. This is fully in line with risk management strategies which focus on the bottom or top portions of the hedged risk inherent in the hedged items. In such case designating the percentage component of the nominal amount is not a suitable way of designation as very well reasoned in the basis for conclusions.

(b) NO, with an example and comments on prepayment options and macro hedging

The prohibition from designating as hedged item a layer component of a contract that includes a prepayment option raises an important concern regarding its implication on macro hedging. ESBG considers that, in case of portfolio hedging, the designated hedged cash-flows should be determined based on economic rather than contractual cash flows, notably for prepayable instruments: the interest rate risk could be isolated from the prepayment risk using expected cash-flows based on the modelling of customers behaviour. Therefore, the prohibition proposed by the ED should not prevent from developing a specific approach for hedge relationship on a portfolio basis (either closed or open).

We do not consider that reasoning in IN22 and BC69 - which prohibits the layer approach for instruments with prepayment options - very well substantiated. We do not agree with the restriction concerning the prepayment options because it limits some hedging strategies which are reasonable from risk management point of view. In order to illustrate our argumentation we believe that an example of bottom layer approach may be relevant:

- **Example**

A bank decides to change the interest rate profile of group of granted loans from a fixed rate to a variable rate and identifies a stable portion which, by experience, is not affected by prepayments. In such case it is irrelevant that fair value changes related to the hedged interest risk are also affected by a prepayment option as it is not part of the designated hedge relationship.

Bottom layer loans are generally not affected by prepayment options and are held until maturity in accordance with original payment schedule. Therefore optional risk is not relevant to fair value such loans when looking at them only as a layer of gross amount of assets.

ESBG understands that when making this decision IASB was more concerned about the fact that a bottom layer approach might be used to replicate the hedges of net positions.

- **Comments on the prepayment Options and macro hedging**

In this regard, ESBG also notes that two agenda papers from August IASB meetings discussing layer approach mention that the exclusion of prepayable items was introduced deliberately because fair value interest rate hedges of fixed rate loans with prepayment options need special consideration which will be addressed in a separate paper. These issues are discussed in the agenda papers 10-10D from the 16 November IASB meeting which are part of macro hedges phase of the hedge accounting project. The papers started to promise development which would allow bottom layer approach for prepayable instruments. We fully support such efforts because they would approach hedge accounting to the actual portfolio management of interest rate risk.



ESBG believes that it would be much more understandable to explain the exclusion of prepayable items from the layer approach as a temporary solution until these issues will be addressed in the separate phase of the project. We are aware that the area of hedging the prepayable items has been a controversial topic over many years. We hope that the discussions regarding the prepayment option will be favourably resolved in the context of macro hedges. However we stress that in such a case, the current exclusion should be also redeliberated for the closed portfolio hedges as a matter of consistency. However if the macro hedges project does not ultimately bring a convenient outcome soon (say until the end of 2011) the IASB should reopen this issue and solve it on the level of the hedges within the scope of this ED.

#### **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?

ESBG agrees that hedge effectiveness requirements are a qualifying criterion for hedge accounting and that current the threshold of 80-125% is arbitrary). We welcome the removal of retrospective effectiveness testing. We consider that requirements for assessing the hedge effectiveness are more risk management oriented.

However for financial entities which use internal derivatives to hedge the risks there will still be a difference between actual risk management practices and testing hedge effectiveness for the hedge accounting purposes. We refer to these issues also in the answer to the question 1 and 7(a).



### 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?

- (a) YES with comments on rebalancing, the need to change them and a corresponding proposal

#### - Comments on rebalancing

Today, systematic and quantitative assessment of effectiveness within a strict threshold leads to potential discontinuance of hedge accounting. It generates a burdensome dedesignation/redesignation process. Therefore, we welcome the introduction of a distinction between rebalancing and discontinuation in addition to the new effectiveness criterion. We also agree with the requirement that when a hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity is required to rebalance the hedging relationship.

However, we are concerned that rebalancing mechanism, as proposed by the ED, is not simple and clear since it needs 6 pages to be described, in application guidance. It could raise operational difficulties as for instance:

- rebalancing is mandatory and could lead to review the hedge ratio at each reporting date;
- several rebalancing could lead to several burdensome effectiveness assessments based on different hedged items characteristics for each rebalanced portion and
- the distinction between rebalancing and discontinuation is not clearly defined in the ED

We encourage IASB to include illustrative examples in order to explain rebalancing clearer. Otherwise the requirements may be misinterpreted in the practice. IASB should not be afraid of adding examples. If they are written in an appropriate manner they do not bring new rules just help in understanding the requirements.

#### - The need to change the principles on the discontinuation of hedge accounting upon rebalancing.

When a bank hedges the risks; it uses internal hedging instruments as already stated in the answer to the question 1. To establish an official hedge accounting the bank has to look for available external hedging instruments. If no external instruments are available to meet the qualifying criteria and bank does not want to enter into new external hedging instruments (due to cost reasons) then the hedge is just not established.

It is against this backdrop that some issues arise. If an entity has to rebalance the hedge and has to find a new hedging instrument to create unbiased relationship three scenarios would be relevant:



- The entity finds a new hedging instrument in the portfolio of existing assets and liabilities;
- The entity does not find the necessary hedging instrument within existing assets and liabilities and enters into new external hedging instrument.
- The entity does not find the necessary hedging instrument within existing assets and liabilities but does not want to enter into new external transaction because external transactions may be costly. In such case a discontinuation of the hedge accounting should be required.

The risk management objectives and strategies are primarily based on the relationship between the hedged risk and the internal hedging instrument. The need to designate an external hedging instrument automatically deviates the hedge accounting from the actual risk management. The reason is that when testing of hedge effectiveness between the hedged risk and the external hedging instrument the result may differ from the actual risk management strategy applied between the hedged risk and the internal derivative.

Currently the paragraph 24 of the ED orders hedge to be discontinued when the hedging relationship ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship). Paragraph B64 of the Application Guidance further explains in the part (a) that discontinuation would happen when hedging relationship no longer meets the risk management objective and strategy on the basis of which it qualified for hedge accounting (i.e. the entity no longer pursues that risk management objective and strategy)<sup>3</sup>.

The question therefore is whether not adjusting the hedging relationship can be considered as a change in risk management objective and strategy. We consider that such a decision would not change the risk management strategy. The real risk management strategy, as written above, is based on the relationship between the hedged risk and internal derivative. Here rebalancing may indeed be performed with internal derivatives or there may be no need to go for rebalancing from internal point of view at all.

However if the new external hedging instrument is not added when it is necessary for the rebalancing it will lead to a biased result when we assess the effectiveness of the relationship between the external hedging instrument and hedged risk and would end up in a paradoxical situation. The objective of hedge effectiveness assessment would have changed (as it is based upon a biased relationship between the external derivative and the hedged risk) whereas the real risk management objective and strategy remains unchanged (as it is based upon relationship between the internal derivative and the hedged risk which is unbiased).

Therefore there is risk for banks. ESBG does not want that the new proposals on hedge accounting standard is interpreted in such a way that it could forced entities to enter into new external transactions because rebalancing is necessary and the actual (underlying) risk management policy does not change.

#### **- Proposal on rebalancing**

To avoid such confusion between the objective of actual risk management and hedge effectiveness assessment we propose that when it is required to rebalance a hedge relationship and when there is no subsequent adjustment then an automatic discontinuation of the hedge should be compulsory. This should be written explicitly in the paragraph B64.

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<sup>3</sup> The two other examples given in B64 (b), (c) are not relevant for this issue.



IASB should address the issue also from more conceptual point of view. It should be explained why there may be need for rebalancing (from external hedging instrument point of view) even when the actual risk management policy does not change (from internal hedging instrument point of view).

(b) YES

Regarding the question (b) we agree with proactive rebalancing based on expectations that the hedge relation might change. If a risk management strategy is forward looking and can capture changes in the trends of the variables involved in the hedge relationship then the entity should have a possibility to reflect this in hedge accounting. Otherwise said, it seems sound to allow an entity to proactively rebalance a hedge relationship if it is expected that this relationship might fail to meet the objective of the hedge effectiveness assessment in the future.

#### **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?

(a) YES

Yes, we agree with the conclusion to discontinue hedge accounting when it ceases to meet the qualifying criteria.

(b) YES

Yes, an entity should not be able to discontinue hedge accounting as long as the risk management objective and strategy remains unchanged. As long as the risk management objective remains the same, it seems logical to forbid any de-designation of hedging relationship that still meets this objective

However in the answer to the question 7(a) we propose that not adjusting the hedge relationship when rebalancing is required results in automatic discontinuation of the hedge.



### 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 agree with the final Board's decision not to fully align accounting for fair value hedge with the accounting for cash flow hedge which would have added undue volatility in OCI.

However we do not agree with the requirement that gains or losses on the hedging instrument and the hedged item should be recognised in other comprehensive income (OCI). We do not think that the double entries of a specific accounting technique should be shown directly on the face of primary statements. What should be recognised is only the final effect of the booking entries – fair value of the hedging instrument, cumulative revaluation of the hedged item in the balance sheet and ineffectiveness in the P&L.

As proposed in the ED the OCI entries do not have any final impact for the statement of comprehensive income as regards the total of OCI. Therefore the steps to show this null result should not be shown either. If users want to see the fair value hedge accounting booking entries they can be provided in the notes.

Moreover it is not clear from the exposure draft how such OCI presentation should really work. We are going to explain this point more in details hereunder.

The ED mentions 3 OCI items:

- (a) the gain or loss from remeasuring the hedging instrument
- (b) the hedging gain or loss on the hedged item
- (c) the ineffective portion transferred from OCI to P&L.

However there is no proposal for amendment of IAS 1.7 where the components of OCI are listed. Therefore, in such circumstances, fair value hedge booking entries might be formally done through OCI accounts but (i) without presenting them in the statement of comprehensive income. This leaves users of financial statements into a complicated situation as the understanding of financial statements will be blurred.

Interpretation of the requirements may further lead to following alternatives described in an example.

#### Example





For example if we take three items (a), (b) and (c) and the effects of the item (a) is +10, item (b) -9 and item (c) -1 ; entities might present in the OCI part of the statement of comprehensive income in two different two alternatives in addition to the (i) presented above.

Either:

- (ii) +1 as some “revaluation of fair value hedges” and  
-1 as “reserve from ineffectiveness from fair value hedges”

Or:

- (iii) +10 “revaluation hedging instrument”  
-9 “revaluation of the hedged item”  
-1 “ineffectiveness of fair value hedges”

As far as we understand the IASB exposure draft we conclude that Alternative (iii) was probably the IASB’s intention. Such free choice would exist as long as the components of OCI are not defined in IAS 1.7.

If IASB keeps the OCI presentation, with which we do not agree, it should amend the IAS 1 accordingly.

## **(b)**

As regards the question (b) we agree with the proposal 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. However we do not agree that the separate line item would be presented next to each line item that contains the hedged asset or liability. Banks hedge large part of their balance sheets and this would extend the number of balance sheet line items significantly. And the reason for this would be more or less technical. Such balance sheet line items cannot be compared with classical line items with major economic content for understanding the financial position of an entity.

Therefore we propose that there is only one line item on the side of assets and one on the side of liabilities. These two line items would be presented within assets for all hedged item which are assets and within liabilities for all hedged items which are liabilities. Therefore they may have negative values e.g. if the cumulative remeasurement of the hedged items is negative. These line items should be broken down and linked to the balance sheet line items in the notes.

The reason for existence of these two line items would also be more technical (as we mention and criticise above). But we support their presentation in order to keep the system of measuring and presenting the financial instruments either at pure amortised cost or at pure fair value.

## **(c) YES**





As to the question (c) linked presentation is not relevant for the ESBG members. However we do not know magnitude of the problems which the gross presentation causes for the specific industry. Therefore we abstain from further commenting on this issue.

#### 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?

(a) YES

We welcome the proposal which enables options to be used as hedging instruments in their entirety.

(b) YES

In order to limit the complexity that the new proposal will introduce, we think it should be desirable that the Board selects a single approach for the reclassification from other comprehensive income to profit or loss of the time value component accumulated in this rubric.

(c) YES

Generally we agree with the notion of 'aligned time value' in the paragraph B68 and the 'lower of test' required by the paragraph B69. However application of this requirement is operationally difficult.

Therefore we propose that aligned time value has to be determined only if there is not a close relationship between the terms of the hedging option and the hedged item. As a result determination of the aligned time value and the lower of test would be required only for hedges for which a quantitative hedge effectiveness test is necessary at the hedge inception. Put in other words, the aligned time value and the lower of test would not be required for hedges for which a qualitative testing of hedge effectiveness is sufficient at the hedge inception.

In addition, the IASB should clarify the notions of "aligned time value" and the already known notion "hypothetical derivative". The IASB should avoid introducing redundant notion that could create confusion among IFRS users.



### 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, with one remark on prepayment options and a question

ESBG appreciates the simplification of the eligibility conditions for group of hedged items. We consider that hedge accounting must be consistent with risk management policy of an entity. Therefore, we agree that a hedged item could be designated on a gross or net basis, as well as on an individual or portfolio basis, since these are ways currently use in practice by entities in order to manage their risks.

As such, the new regulation in the paragraph 34 (a), (b) is sufficient for our members to apply the cash flow hedge strategies at the level of group of items.

- **Remark** on group of hedged items with prepayment options

we would like to emphasise that the proposal to prohibit the layer approach for the groups of hedged items with prepayment options effectively prevents us from applying fair value hedge accounting for some of our portfolio hedges. We refer to this issue in the answer to the question 5(b).

Furthermore ESBG believes that it will only be possible to provide a more comprehensive answer concerning group fair value hedges when the proposals on macro hedge will be available.

- **Question**

Finally, while we do not consider the restriction in the paragraph 34(c) (offsetting cash flows in the group of hedged items must affect profit or loss in the same reporting period) as relevant for banking business. But we wonder what would be the impact on our clients. Therefore we have some concerns regarding the 3<sup>rd</sup> criterion in which cash flow hedge accounting is not permitted for groups of items with offsetting cash flows that affect profit or loss in different reporting periods: this criterion seems too restrictive.

### 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?

YES.



### 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) & (b) YES but with remarks on some disclosures and corresponding proposal

In order to justify the use of hedge accounting in accordance with their risk management policies, we consider that entities should refine the description of their risk management policies and strategies.

Therefore, we globally agree with the proposed disclosure requirements that provide improved information about the entity's risk management strategies and the effect of hedge accounting on financial statements.

- **Remarks** on disclosures in paragraph 52 and 51

The disclosure requirements in the paragraph 52 are unclear for us. There are several points which we would like to comment.

The required reconciliation is to be provided either *in the statement of changes in equity* or in the notes. We are surprised to see that such highly technical reconciliation may be shown on the face of the statement of changes in equity.

The underlying principle for the IAS 1 revision, which was performed several years ago, was to separate owner and non-owner changes in equity. However, in paragraph IAS1. IN 13, it is written that '*An entity is not permitted to present components of comprehensive income (i.e. non-owner changes in equity) in the statement of changes in equity*'. Therefore all OCI entries are non-owner changes in equity and therefore have nothing to do with the statement of changes in equity. This is very confusing.

Furthermore the footnote (a) in the first table of Illustrative Examples 3 says that '*The information disclosed in the statement of changes in equity (cash flow hedge reserve) should have the same level of detail as the proposed disclosures requirements*'. This seems to be a direct reference to the level of detail of OCI disclosures which have to be shown on the face of the statement of changes in equity. Such order would be applicable even if paragraph 52 disclosures were provided in the notes. We cannot understand it in the light of the principle mentioned above.

- **Proposal:** disclosures in paragraph 52 should be provided in the notes only.

ED paragraph IE 3 shows how paragraph 52 may be applied. It refers to a tabular format which is relevant for these disclosures. However the tabular format is not mentioned anywhere in the paragraph 52. It is the paragraph 51 which refers to the tabular format of disclosures.

We expect that reconciliation of accumulated OCI required by paragraph 52 should show both opening and closing balances of the OCI items (e.g. cash flow hedge reserve). However, the illustrative example IE 3 does not show any opening and closing balances.



Therefore the requirements of paragraph 52 should be better aligned with paragraph 51 and should also require a tabular format which would be in line with IAS 1. For a better understanding of the links illustrative example part should cover all the requirements which are currently in the paragraphs 51 and 52.

#### **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?

YES

We consider it very reasonable.

#### **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?

(a) and (b) NO, the use of CDS should be allowed. Proposal for redrafting

#### **Allowing the use of CDS, a question of consistency**

We welcome that IASB addresses the issue of hedging the credit risk in its discussions. This issue significantly impacts financial entities. We disagree with the IASB. Credit default swaps (CDS) are suitable hedging instruments for hedging the credit risk.

The IASB argues that hedge accounting is not achievable to account for hedges of credit risk using credit derivatives because “measuring the credit risk component of a loan or a loan commitment is complex” (BC225) and that, consequently, an alternative accounting treatment (other than hedge accounting) is considered.

We admit that there is a rationale in the argumentation found in the paragraphs BC 221, 222 that credit default prices might not be suitable for measuring the credit risk component of a financial instrument. This is true if we are focused on getting the best possible theoretical value of the credit risk.

- But, first of all, such determination is complex if not impossible. In the risk management practice CDSs are used as the best instrument which is available to hedge the credit risk. Such risk management practice is recognised also by IASB in the basis of conclusions. Markets with



CDSs are liquid and provide a transparent way of measuring the credit risk. Therefore we ask the IASB to be consistent and accept CDS.

- Secondly, while we agree that assessing credit risk may be challenging, many entities (mainly banks or insurance companies) are currently managing this risk in practice which is or will become a strategic activity. Moreover, credit derivative is the only and best derivative instrument to economically hedge credit risk, which is commonly used by market participant. If credit derivatives were not an appropriate economical hedging instrument, as the IASB seems to assert, this would raise a huge arbitrage opportunity for market participants. Furthermore, both banks and insurance regulators accept credit derivatives as a hedge of credit risk, under certain conditions. Thus, easing the use of credit derivatives as hedging instruments for hedge accounting would be consistent with the main objective of the ED, i.e. improve the link between accounting and risk management activities.
- Thirdly, asserting that credit risk is not an eligible hedged component (i.e. separately identifiable and reliably measurable) in a hedge relationship does not seem consistent with other IFRS requirements, such as the fair value option for financial liabilities which requires the entity to present the effect of changes in the liability's credit risk in OCI or the impairment of financial assets that would require entities to assess expected credit losses.
- Last but not least, prohibiting credit default swaps in hedge accounting for credit risk is in contradiction to the principles that ED is focused on actual risk management practices and also allows designation of a risk component as being hedged. It is allowed to hedge even non-contractual risk components. In paragraph B16 we can find an example that jet fuel purchases may be hedged on the basis of crude oil price component. We find this example sound, and we agree with it. But then we do not see a reason why we should not find such a clear economic relationship between the credit risk of a financial asset and a CDS.

Therefore, we consider that hedge accounting must be eligible for credit derivatives hedging credit risk component of financial instruments. We consider that the Board should further explore a way to avoid the current accounting mismatch, as tentatively decided in October 2010, for instance by accounting for the premium on the credit derivatives in way that it is allocated over time by using other comprehensive income, which is the proposed treatment for options, or an accounting similar to insurance contracts.

In any case, the three alternatives proposed by the Board are not satisfactory since it is based on fair value option which implies to recognise all changes in fair value in P&L, including components that may not be hedged by the entity, such as the interest rate risk.

## **Proposal**

Therefore we propose to withdraw the paragraphs in the basis of conclusion discussing the hedges of credit risk using credit derivatives. This would permit to us credit default swaps as hedging instrument by using a standard hedge accounting mechanism. The IASB may additionally introduce some restricting criteria for such hedges. Such criteria however should not end up with rules which restrict hedge accounting of a credit risk to a minimum. A reasonable requirement may be that there is a substantive economic relationship between the credit risk of the hedged item and the credit default swap.



#### Question 16

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

PARTIALLY, the date of 1 January 2013 is unrealistic

We agree with the proposal to apply the new hedge accounting requirements prospectively. It is more operational than a full retrospective one.

However the proposed effectiveness date 1 January 2013 is unrealistic considering all major IFRS changes which entities face currently and in the years to come. We hope you will take into account our comments to revise this proposed date.

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ESBG, against the background of the list of issues of the introduction would like to add three additional comments which we believe are important.

These additional comments concern:

1. the sub-Libor issue,
2. time portions of hedging instruments and
3. determination of the present value of the change in the hedged cash flows

Please note that ESBG proactive paper on hedge accounting that we sent you in January 2010 is also included in Appendix to our answers to your questions.

#### Additional comments

##### **The sub-Libor issue<sup>4</sup>: allowing banks to properly report their risk management strategies**

ESBG disagrees with the IASB decision to maintain the restriction in IAS 39 regarding the designation of risk components when the designated component exceeds the total cash flows of the hedged item, namely the sub-libor issue.

We understand very well the arguments of IASB's Basis for Conclusions and of the related staff papers that designation of Libor components for liabilities with sub-Libor rate may lead to a counterintuitive

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<sup>4</sup> "Sub-Libor" is a general term referring to the cases when variable rates are linked to reference rates. In our case the most common reference rate is Euribor.



results. Indeed, the floor element may produce additional negative cash flows if Libor falls below the absolute value of the negative margin. But we believe that this optional element (floor) is not something which should prohibit hedge accounting but should rather result in recognition of ineffectiveness.

However ESBG considers that this prohibition is not consistent with the principle proposed by the exposure draft on the designation of risk component as hedged items.

- First of all because the goal of the ED is to represent, in the financial reporting, the extent and effects of the entity's risk management activities. This restrictive rule will prevent banks from reporting properly in their financial statements their actual interest rate risk management activities.

In case Euribor falls below the margin this should not lead to hedge rebalancing if the risk management strategy is not to hedge such negative residual component but rather assume the risk and its negative consequences.

Said otherwise, if the risk management strategy is to hedge the variable rate liabilities with negative margins to Euribor and to bear the risk of further negative cash flows in case Euribor is below the absolute value of the margin, such strategy should be permitted for hedge accounting. Accounting rules should never change the way business is decided. And indeed such hedging strategies are applied in practice.

- Secondly, because the IASB tries to match accounting rules with the economic reality. Economically a risk component may be higher than the contractual cash flow of the hedged instrument, as are, for instance, sub-libor instruments. Therefore the principles of hedge accounting should not take into account the sign of the margin. A bond paying libor with a margin - whatever the sign of the margin is (negative or positive) - must be eligible for hedge accounting for the portion related only to the libor risk.
- The inclusion of core deposits, which form a major part of the European banks' liability-side, as eligible hedged items is crucial should hedge accounting principles be aligned with the actual management of interest rate risk. In Continental Europe all statistics show that core deposits are the more stable liabilities a bank can count on. The fundamental social value of banks is to harvest the portfolio effects that simply do not exist at transaction level, the most important of which is to transform contractually short term deposits into long term loans that are needed by the economy.

ESBG also believes that the floor should rather result in recognition of ineffectiveness. The interest rate floor raised by the Board to support its decision is a potential source of ineffectiveness and should be treated as such if and when it occurs. It should not lead to the prohibition of a portion as hedged item.

The negative cash flows which the entity faces when using such hedge constructions for liabilities should be fully recognised as an ineffectiveness in P&L. Such ineffectiveness should not be taken for hedge effectiveness testing purposes if it is in line with risk management strategy. Therefore it should not lead to a termination of the hedge or to rebalancing. Such ineffectiveness should be recognised when determining the booking entries. It means that the ineffectiveness recognised should reflect the losses which the entity faces and the intrinsic value of the floor may be a faithful representation of such losses.





### **Time portions of hedging instruments: further clarification is needed**

ESBG has some comments on paragraph 8 of the ED which states: *“However, hedging instrument cannot be designated for only a portion of the time period during which a hedging instrument remains outstanding”*. This rule has been transferred from IAS 39.75. This sentence is not easy to understand and more interpretations can be encountered in the practice. Many ESBG members, located in Central and Eastern Europe, face stricter interpretation of accounting rules than the interpretation that is currently being performed in Western Europe.

Such an interpretation would be that the maturity of the hedging instrument cannot be longer than the maturity of the hedged item. This prohibits some hedging strategies from qualifying for hedge accounting and creates a serious issue. This was probably not the aim of IASB.

When interpreting this rule some guidance could be found in the Basis for Conclusions and the Guidance on Implementing of IAS 39. However the ED does not discuss this rule at all in any part of it. Therefore the need for clarification is even more important in the future standard. We are of opinion that the rule should be reformulated or further clarification should be provided.

### **Cash flow hedges – present value of the change in the hedged cash flows**

We welcome the clarification in the paragraph 29(a),(ii) saying that a hedged item in a cash flow hedge should be assessed based on “the present value of the change in the hedged expected future cash flows”. This replaces the IAS 39 requirement in IAS 39.96(a),(ii) referring to “the cumulative change in fair value (present value) of the expected future cash flows on the hedged item...” which does not work when taken literally.

However the ED paragraph 29(a),(ii) still uses the old IAS 39 wording “the cumulative change in fair value (present value) of the hedged item...” and equates it to the correct principle “the present value of the change in the hedged expected future cash flows” (which comes only in the bracket). We consider it rather misleading.

We would also like to comment on another issue connected with this area. Calculating the changes of the expected cash flows on the hedged item *on present value basis* is not substantiated for hedging the spot rate risk in foreign currency hedges. Several ESBG members explained that when hedging the spot Foreign Exchange (FX) risk of forecast transactions the *present value* of the change in the hedged cash flows does not match the spot revaluation of the hedging instrument.

FX revaluation of the non-derivative hedging instruments reflects the cumulative changes in the spot rates. It should be matched to the hedged cash flows which also reflect the spot rates changes and are not discounted. These spot rate changes are recorded for the period that has passed. Including the discounting over the remaining hedge period introduces artificial elements in such hedges.



# POSITION PAPER



## APPENDIX

### ESBG position paper on portfolio hedge accounting

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ESBG Register ID 8765978796-80

12 January 2010





Doc 0042/2010  
HAG/RDE

## 2. Introduction

The world has experienced a dramatic financial crisis and there is a clear need to address the rules on accounting for financial instruments. This necessary improvement can only be achieved if accounting appropriately reproduces the economic reality and takes into account the specificities of the business model of savings and retail banks. Indeed, banks finance two third of the European economy while capital markets finance only one third of it. In addition, the crisis has demonstrated that savings and retail banks' business model - which consists in originating loans, holding these loans on their balance sheets and funding them with stable resources such as demand deposits - proved to be extremely resilient during the crisis as opposed to the originate-and-distribute business model.

The IASB project to replace IAS 39 consists of three main phases and hedge accounting is the third phase. ESBG would like to take the opportunity to affirm its position on this topic. More precisely, as the main issue for ESBG members appears to be portfolio hedge accounting, ESBG's Position Paper will focus on the key messages and principles on which portfolio hedge accounting should be based upon.

ESBG believes in the importance of working towards the adoption of a solution to ensure that all European banks can implement the same hedge accounting provisions. At the same time, we consider it of utmost importance to find a solution that takes into account the risk management practices applied by banking organisations.

## 3. ESBG draft Position on portfolio hedging

ESBG strongly supports the IASB in looking for a more practical application of the International Financial Reporting Standards (IFRS) and especially concerning portfolio hedge accounting. However, ESBG has some concerns on the piecemeal approach that the IASB has decided to follow. ESBG would have preferred individual and portfolio hedging to be treated at the same time and not split into two phases. This approach could result in unintended consequences for portfolio hedging which is of the utmost importance to us.

We firmly believe that the "business model" should be the primary criteria for the classification and measurement of a financial instrument. In accordance with the IASB, we also consider that an "*entity's business model does not relate to a choice (i.e. it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way that an entity is managed, and information is provided to the management of the entity*" (IFRS 9 - BC 32). We stress that the need to introduce anti-cyclical measures to financial reporting has become, for us, self-explanatory and we consider that giving more consideration to the business model would prevent undue volatility. We also believe that financial statements can provide an adequate representation of the results and present information only through consistency between the management of a financial instrument and its classification measurement criteria.



### **3.1. Hedge accounting should be based on the business model and principle based**

As far as hedge accounting is concerned, we would encourage the Board to define accounting principles that adequately reflect the economic and financial reality of interest rate risk management. An appropriate accounting representation of the effects of sound risk management techniques would certainly provide relevant and useful information to the readers of financial statements. It is highly important that appropriate hedge accounting rules avoid undue volatility in Profit & Loss (P&L).

Hedge accounting principles should be consistent with the principles of sound risk management, in particular the techniques used to manage interest rate risk in the Asset and Liability Management (ALM). Only by referring to risk reduction techniques used by banks, hedge accounting principles would draw the adequate line between risk reduction strategies techniques and trading activities.

Finally, we consider that hedge accounting principles should be principle based. A principle-based approach is more robust and responsive to developments in markets, products and hedging strategies.

### **3.2. Description of ALM activities in banks**

Interest rate risk arises from mismatches between assets and liabilities kept on the balance sheet: the bank P&L does not results from the absolute levels of interest on loans and on funding, but rather from the difference between them. This difference is not always constant, as it is impacted by the various commercial rates granted on both sides and by maturity mismatches between assets and liabilities.

These interest rate risks resulting from this originate-and-hold business model are managed on a portfolio basis through ALM strategies. ALM refers to the management of risks incurred by the bank with respect to its activity as an intermediary between economic agents that have different needs and risk appetites. Therefore, ALM allows for the transformation of short term resources into long term uses. More precisely:

- The revenue of the bank comes from the collection of contractual cash flows over time from financial instruments that are held in the balance sheet (customer loans and deposits, interbank lending and various ALM financial instruments).
- The risk management consists of reducing the variability of the margin due to the mismatches by entering into hedging transactions which offset part or all of the mismatches.

As a consequence, the purpose of hedging is not to manage the fair value exposure of the asset or liability but to achieve a target interest margin.

### **3.3. The concept of portfolio hedging**

Savings banks mainly manage their risks on a portfolio basis. In our opinion, acknowledging this when drafting hedge accounting rules is the only way forward to simplify accounting for financial instruments.



It is imperative that the concept of “portfolio hedging”, which is the cornerstone of asset and liability management strategy, be recognised by the IASB. The IASB should recognise that through risk mutualisation, the risk of the portfolio is not the same as the sum of the risks of each item of the portfolio. Indeed, portfolio hedging follows an economical and statistical treatment which is quite different from an individual hedging. This is why economic cash flows should prevail over contractual cash flows. Banks should have the possibility to sum up cash flows from a pool of transactions and hedge them on a portfolio basis.

### **3.4. A bottom layer approach is consistent with the business model**

Risks on the banking book can be separated into two components: interest rate risk and prepayment risk. Banks do not try to hedge the entire risk attached to the assets and liabilities scheduled by time periods. They only try to hedge the interest rate risk related to the stable non-prepayable portion. The part of the net position which is not hedged is supposed to capture the prepayment option.

When assessing the more appropriate approach to measure hedge effectiveness in a portfolio hedge of interest rate risk, we believe that the IASB should favour the method reflecting as much as possible to the true hedged item targeted by the ALM. Asset and liability management is not aimed at cancelling all the interest rate risks, but is aimed at reducing it. We do not believe that over-hedging and under-hedging have the same effect in terms of ineffectiveness. When the objective is to under-hedge a risk exposure, the hedging position should be considered as effective as long as they reduce the risk exposure.

When an entity hedges a portfolio of fixed-rate loans it adopts a bottom-layer approach that should be recognised by accounting standards in order to be consistent with real asset and liability management. This would result in recognizing ineffectiveness only in case of over-hedging.

### **3.5. Core deposits should be eligible hedged items**

The inclusion of core deposits, which form a major part of the European banks' liability-side, as eligible hedged items is crucial should hedge accounting principles be aligned with the actual management of interest rate risk. In Continental Europe all statistics show that core deposits are the more stable liabilities a bank can count on. The fundamental social value of banks is to harvest the portfolio effects that simply do not exist at transaction level, the most important of which is to transform contractually short term deposits into long term loans that are needed by the economy.

In other words, the retail activity of banks consists in matching theoretically short-term, but in substance long-term resources into medium and long-term assets. The most important difference between theoretical and effective maturity is observed on core deposits. Therefore, it is crucial that we:

- recognise that behaviourized demand deposits give rise to interest rate risk and should therefore be hedgeable items;
- include core deposits in the portfolio hedged and schedule them into time bands reflecting the expected withdrawals instead of the contractual ones.



### **3.6. Only risks transferable to the market are hedged**

Banks only hedge risks that are transferable to financial markets: inter-bank interest rates, excluding credit spread on both assets and liabilities. We believe that the replacement of IAS 39 should authorise banks to exclude the margin of the liabilities which are hedged. Hedging interest rate risk, excluding margins on both assets and liabilities should be allowed. This is currently not the case as IAS 39 authorises banks to exclude the margins on the asset side but not on the liability side (the “LIBOR minus” issue). Partial hedging should be authorised risk-wise: hedging interest rate risk within assets/liabilities excluding the commercial margins

### **3.7. Effectiveness tests and risk reduction**

As a banking association, we recognise that effectiveness tests are required in order to demonstrate the hedging nature of derivatives, hence deserve hedge accounting treatment. Our main point is that effectiveness tests should be aligned with risk management methods. It is important to simplify and align the accounting treatment of hedge accounting as much as possible with the way ALM is performed.

As ESBG considers that accounting rules should reflect the reality, effectiveness tests should not concern full risk reduction but should instead consist in demonstrating a sensible reduction of the risk over the portfolio. More precisely, we would propose to set up effectiveness tests that will consist of demonstrating the reduction of the sensitivity of the hedged portfolio to interest rate risks.

### **3.8. Hedge Accounting should not increase volatility in the Other Comprehensive Income category**

Fair value hedge accounting should not increase volatility in the Other Comprehensive Income (OCI) category. Reporting OCI volatility is not appropriate in this case because both hedged items and hedged instruments are on the balance sheet and their fair value changes are offset. This could also have dramatic prudential consequences in terms of solvency ratios if such hedge reserve in OCI is not filtered. We deem it highly desirable that both accounting and prudential principles recommended by banking supervisors for ALM lead to converging treatments.



## About ESBG (European Savings Banks Group)

### ESBG – The European Voice of Savings and Retail Banking

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5,972 billion (1 January 2008). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. ESBG member banks have reinvested *responsibly* in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.



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Published by the ESBG, March 2011