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International Accounting Standards Board
30 Cannon Street
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Exposure Draft ED/2010/13
Hedge Accounting

Dear Sirs,

Allied Irish Banks, p.l.c. appreciates the opportunity to respond to the above Exposure Draft.

We welcome the stated intention of the IASB to allow hedge accounting to be more closely aligned with risk management policies and objectives.

We would highlight the difficulty in attempting to finalise a standard on Hedge Accounting before developing a model for macro / portfolio hedging. We believe that elements of the general Hedge Accounting proposals may need to be re-exposed following publication of the macro / portfolio hedging proposals. We are concerned about the operational implications of the proposals around rebalancing of hedge relationships, and believe that rebalancing should not be mandatory. Furthermore, voluntary de-designation is important in the operation of hedge accounting for banks where risk is often managed on a net basis.

We support a principles-based approach to hedge accounting. Accordingly, we do not support prohibition of hedge accounting for credit risk: we believe a workable hedge accounting solution should be permissible, provided the risk component is separately identifiable and reliably measurable. We would welcome an amendment to the proposals to permit the designation of a LIBOR component in a sub-LIBOR instrument (the 'sub-LIBOR' issue), provided it is consistent with the entity's risk management objective. We do not agree that hedge accounting should be restricted to risks that could affect profit or loss, and would welcome application of hedge accounting for items that affect other comprehensive income or equity.

Question 1

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

Answer 1

We welcome the stated intention of the IASB to allow hedge accounting to be more closely with risk management policies and objectives. However, whilst the ED is pitched with this objective and at a principles-based level, we believe that some of the proposals are rules-based and not consistent with a Hedge Accounting standard which intends to integrate with an entity's risk management objective.

Furthermore, we are concerned that existing hedge relationships may be jeopardised by the risk management objective requirement. Under IAS 39 (IG F.6.2 (a)), it is currently permissible to apply hedge accounting independently of the economic purpose for the transaction, particularly where hedge accounting reflecting the economic basis is restricted for whatever reason. We believe that the ED (notably B53) may be interpreted to mean that an entity must discontinue hedge accounting where the hedge relationship is not aligned to the entity's risk management objective and would welcome clarification that this is not the case.

We agree that application of hedge accounting should not be mandatory.

We do not agree that hedge accounting should be restricted to risks that could affect profit or loss. We would welcome application of hedge accounting for items that affect other comprehensive income or equity.

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?

Answer 2

We have no objection to the proposal.

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 to you recommend and why?

Answer 3

We broadly welcome the proposals with regard to hedging aggregated exposures. We would welcome clarification on how this is expected to work in practice, particularly how the layered derivatives would be measured and accounted for (example B9).

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?

Answer 4

Yes, we agree.

For this reason, we believe that hedge accounting should be possible for situations in which credit risk is hedged by credit derivatives, provided that the risk component is separately identifiable and reliably measurable.

We would welcome an amendment to the proposals in B24 to permit the designation of a LIBOR component in a sub-LIBOR instrument (the 'sub-LIBOR' issue), provided it is consistent with the entity's risk management objective. We find this restriction inconsistent with a principles-based standard concerned with alignment with an entity's risk management objective.

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?**

Answer 5

(a) We support the proposal to allow designation of a layer of the nominal amount of an item as the hedged item. (b) In a principles-based standard, we do not believe it to be appropriate to prohibit hedge accounting for a layer component of a contract that includes a prepayment option.

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what changes do you recommend and why?

Answer 6

Whilst in theory we would welcome the removal of the quantitative threshold and retrospective assessment for hedge effectiveness testing, we wonder whether the benefits of this removal will be seen in practice. We would request more clarity on the hedge effectiveness assessment as set out in 19(c).

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?**

Answer 7

We do not agree that there should be a mandatory requirement for rebalancing of a hedging relationship with continuation of the relationship; we believe that any rebalancing should be voluntary. We are concerned at how far this proposal may be taken: we cannot envisage a situation where it would be appropriate for an entity to be mandated to enter into external transactions purely to comply with a mandatory rebalancing requirement under an Accounting Standard.

We are concerned about the practical implications of rebalancing. We believe that paragraphs B29-B31 may preclude application of a 100% ratio, which, even though it may result in some ineffectiveness, is often an easier ratio to apply in practice, given systems and process constraints. The rebalancing outlined in B55 seems onerous to manage at an operational level.

We support proactive rebalancing of the hedge relationship provided this is voluntary.

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?**

Answer 8

(a) We agree that a change in risk management strategy should trigger discontinuation of hedge accounting, but only where it results in the hedge relationship no longer meeting criteria. We also believe that the risk management strategy needs to be assessed on a case by case, hedge by hedge basis.

(b) We do not agree with the proposed prohibition on voluntarily discontinuing hedge accounting. Voluntary de-designation may be important in the operation of hedge

accounting for banks where risk is often managed on a net basis. As noted in our response to Question 1, we do not believe that application of hedge accounting should be mandatory.

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?**

Answer 9

(a) We do not believe that the change is desirable, given that the net result will be unchanged. (b) We do not support inclusion of a separate line item for each hedged item / hedged risk; rather we believe the inclusion of a single line item in the statement of financial position for all hedged items may be more appropriate.

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 sale 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?**

Answer 10

We welcome the proposals with regard to the accounting for the time value of options, which we believe may make hedge accounting for options more accessible.

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?

Answer 11

We believe the proposed approach will be more accessible than that in IAS 39. We welcome the removal of the 'approximately proportional' criteria for hedging of gross positions. However, we believe that net position hedging will still be confined to designation of gross positions (B73). We would highlight the difficulty in attempting to finalise a standard on general Hedge Accounting before developing a model for macro / portfolio hedging.

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?

Answer 12

We have no objection to this proposal.

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?**

Answer 13

We support a principles-based approach to disclosures, focussed on better quality rather than simply more disclosures. Our preliminary comment on the proposed disclosures is that they appear to be very prescriptive and some aspects of the disclosures may be difficult to operate in practice. The usefulness of the information may be different, depending on the business model and risk management objective of the entity.

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?

Answer 14

We have no objection to this proposal.

Question 15

- (a) **Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedged 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?**

Answer 15

We find largely unhelpful the 3 alternative approaches to address situations in which credit risk is hedged by credit derivatives. We believe that a workable hedge accounting solution should be permissible for situations in which credit risk is hedged by credit derivatives, provided that the risk component is separately identifiable and reliably measurable.

Question 16

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

Answer 16

We would support a later effective date, given the requirement for EU endorsement, and given that the proposal for portfolio / macro hedging, which is such a significant element for banks, has not yet been published. We agree that early adoption should be permitted.

If you require clarification with regard to the above, please do not hesitate to contact me.

Yours faithfully,

Ailbhe Whyte
Allied Irish Banks, p.l.c.