



Indian Banks' Association

CORPORATE & INTERNATIONAL BANKING

No.C&I/ED/2010-11/2655

March 9, 2011

The Chairman
International Accounting Standards Board (IASB)
30 Cannon Street
London
EC4M 6XH
UK

Dear Sir

Comment letter on IASB Exposure Draft ED/2010/13 *Hedge Accounting*

We refer to the exposure draft released by you in December 2010 relating to Hedge Accounting.

We appreciate the opportunity to respond to Exposure Draft ED/2010/13 *Hedge Accounting*, issued by the IASB. We have consulted within the members of the Indian Banks' Association (IBA) Sub Group on IFRS Transition in respect of this letter, which represents the views of the Group.

We furnish below our comments on this ED.

• Question 1

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

The objective as proposed in the ED is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage the exposures arising from particular risks that could affect profit or loss.

There was no specific objective for hedge accounting in IAS 39. Hence we believe that this will be helpful in understanding a less rules based standard.

However, there are two issues involved in it :

- (a) Hedges of investments in equity instruments carried at fair value through OCI will not qualify for hedge accounting. We believe that the effects of actual risk management activities will not be reflected in the financial statements if this will not qualify for hedge accounting.
- (b) ED does not include the use of internal derivatives as hedging instruments. There will be a gap between the Group's risk management strategy and the hedge accounting as banks pass on some risks to their group companies. Trading book combines risk positions from all external and internal dealings and manages the risk within the delegated risk limits. Therefore, it may happen that there will not be an external derivative that matches each internal derivative within the trading book. Therefore, ED should permit the use of internal derivatives as hedging instruments.

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- 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?

We believe 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 but at the same time, we also feel that eligibility of being designated as a hedging instrument should also be extended to non-derivative financial instruments measured at fair value through OCI.

- 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?

We believe that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item as it is in line with the proposed objective of reflecting risk management activities in the financial statements.

- 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?

The ED proposes to allow specific risk components to be designated as a hedged item regardless of whether they are part of a financial or a non-financial item if they are "separately identifiable and reliably measurable". We welcome this approach of not having different requirements for financial and non-financial instruments as this provides a more consistent treatment for components of financial and non-financial items and this would more closely align hedge accounting with risk management.

- 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. We support the change proposed in the ED regarding designating a layer of the nominal amount of an item as the hedged item as this change will be in line with the risk management strategies of the entity. But at the same time, how practically this will be done is not clear i.e. some detailed guidance needs to be provided for designating a layer of the nominal amount of an item as the hedged item.

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- b. We do not agree with the proposal that precludes layer components of contracts that include a prepayment option from the scope of eligible hedged items. This will be an issue for us as we have the significant volumes of loan portfolios including prepayment options. Hence, we request IASB to consider and resolve favourably this issue in the context of portfolio hedging by analysing the impact of this issue. We believe that the existence of a prepayment option can cause measurement related complexity but should not be the reason to preclude hedge accounting.

• 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?

Yes, we agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting as the main purpose of hedging is to offset the risk exposure and hedge accounting is a mechanism to reflect the results of some risk management activities. Hence, unless and until the hedge effectiveness will be there, hedge accounting will not meet its basic objective. Further, we stand to gain from the new proposals because hedge effectiveness testing will be much simpler and will be required only on a prospective basis. Qualitative testing will be possible wherever appropriate and there will be no test of 80 – 125% for hedge effectiveness. The exposure draft provides a qualitative assessment for critical terms matched items and a quantitative approach for others. However, more detailed guidance needs to be provided on the same as such a model would unduly expand the hedge accounting base.

• 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. We agree with the proposal in the ED that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment, an entity is required to rebalance the hedging relationship. However, the only method of rebalancing as stated in the ED is that it can be achieved through the change in the volume of either the hedged item or hedging instrument whereas, we feel that there may be some situations where it can be achieved through other alternatives viz., transacting additional derivatives that change the risk profile of hedging derivative in line with the existing risk management strategy.

b. We are in agreement with the proposal of proactive rebalancing in the ED as if rebalancing is done timely, then it would meet the objective of hedge effectiveness assessment and it is a forward looking approach.

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?**

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- 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. We agree with the proposal of discontinuing hedge accounting when the hedging relationship ceases to meet the qualifying criteria
 - b. We also agree with the proposal that voluntary discontinuation should not be allowed.
- 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 do not fully support the proposal by the Board 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 (OCI) with the ineffective portion transferred to profit or loss as this would not provide any additional useful information to the users. Further, it artificially increases the number of items recognised in OCI as it has no real impact on profit or loss. We feel that only the final effect of the entries should be recognised. The objective of presentation/disclosure of ineffective portion can be achieved by adding a disclosure requirement to show the ineffective portion of fair value hedges as a separate in profit or loss statement.
 - b. Yes, the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position as it would reflect separately the impact of measurement adjustments to the hedged items and users of the financial statements can get a clear picture from it. But at the same time, we do not agree that the separate line item would be presented next to each line item that contains the hedged asset or liability as this would unduly extend the number of balance sheet line items.
 - c. We agree with the proposal envisaged in the ED regarding the linked presentation that it should not be allowed as it may create confusion.
- 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 OCI should be reclassified in accordance with the general requirements (e.g. 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?

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- 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 (i.e. the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

We support the proposal which enables options to be used as hedging instruments. The overall impact will be beneficial as it will reduce the volatility that results from the current requirements of IAS 39. But the accounting requirements are very complex particularly the concept of aligned time value. We request the IASB to provide a detailed guidance to calculate the aligned time value.

- 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. When all the items of the group are exposed to similar risks, clubbing of group items is required. The eligibility conditions of groups of items as a hedged item are simplified to some extent in the proposed ED. The individual items in the group no longer need to move proportionately with the group to allow a hedge of the group. But in the case of cash flow hedge, the condition that the offsetting cash flows in a group of net positions must affect profit or loss within the same reporting period may be an important constraint. However, we would be able to analyse the potential issues only after the development of macro hedging model.

- 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?

We agree with it because, as well reasoned in the ED that, if it is proposed to adjust (gross up) all the affected line items in the income statement, the result would be the recognition of gross gains or losses that do not exist.

- 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?

Generally we agree with the proposed disclosure requirements and do not propose any other disclosures except the one specified by us in our response to 9(a).



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• Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

We have no specific feedback to offer on this area.

• 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?

We appreciate the efforts put by the board in considering the alternative accounting treatments to account for hedges of credit risk using credit derivatives, but we believe that not performing the hedge accounting in the case of credit derivatives which play a significant role in offsetting risks will be in contradiction of the general principle of aligning hedge accounting with the actual risk management strategy of the entity. In fact, Reserve Bank of India (the Central Bank of the Country) is seriously contemplating to introduce this product in India in the near future. Most of the banks in India would be resorting to this derivative product to reduce their credit risk on their loan portfolio. If this derivative is not permitted for off-setting the credit risk, the product may fail as well as banks may not be tempted to subscribe to this product.

• Question 16

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

We agree with the proposal of prospective application. But we feel that the effective date for transition should be later than 1 January 2013 looking to the issues involved in the new hedge accounting model proposed.

With kind regards,

Yours faithfully,


(S S N Murthy)
Sr. Vice President