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Re: IASB Exposure Draft ED/2010/13: Hedge Accounting

Dear Sir David,

Commerzbank Aktiengesellschaft¹ appreciates the opportunity to comment on the IASB's Exposure Draft ED/2010/13 Hedge Accounting issued in December 2010 (the "ED").

We welcome the ED as a major milestone towards reducing the complexity and burden of applying the current hedge accounting model in IAS 39. Overall, we are supportive of the direction the hedge accounting exposure draft has proposed to take:

- Establishing a more principle-based approach to applying hedge accounting;
- Aligning closer hedge accounting with the risk management activities of an entity; and
- Reducing or eliminating some of the more operationally onerous hedge accounting requirements in IAS 39 such as the bright-line quantitative (80% - 125%) threshold and retrospective assessment for hedge effectiveness testing.

However, we have concerns on the general aspects pertaining to the hedge accounting phase as well as a number of specific proposals contained in the ED that could potentially introduce new unintended complexities in the application of hedge accounting. We highlight below those concerns which we consider to be most significant.

¹ Commerzbank Aktiengesellschaft is the second largest credit institution in Germany, and one of the leading financial institutions in Europe. Following the takeover of Dresdner Bank in 2009, Commerzbank is the leading bank for private and corporate banking in Germany. The bank serves approximately 15 million customers worldwide.

(1) General Aspects

(a) Due Process

We note that the focus of the proposed changes in the ED pertains to the general hedge accounting requirements, limited to only hedges of single items or hedges of closed groups of items. The ED does not address a key issue that the banking industry faces in the application of hedge accounting today, open portfolio macro hedging ("macro hedging"). Instead, the IASB has decided to address macro hedging as part of a subsequent exposure draft, in order to benefit from the comments and feedbacks received on the general hedge accounting model proposals as contained in the ED. We are concerned with this phase approach undertaken by the IASB for the hedge accounting phase. This is because of the considerable interdependencies that exist between the phases.

In the case of the 2-phase approach for hedge accounting, we are concerned that certain prohibitions in the ED (e.g. prohibition of voluntary de-designation, prohibition to designate a layer component of a contract that contains a prepayment option as a hedged item if the prepayment option's fair value is affected by changes in the hedged risk, or the restrictions concerning the so-called sub-LIBOR hedged items) could set precedents in the subsequent discussion on macro hedging. Unlike hedges of single items or hedges in closed portfolios, the level of complexity in macro hedging is more profound and unique. Therefore, certain proposals in the ED would make it more difficult to apply hedge accounting for macro hedging, especially when the goal is to align hedge accounting more closely with risk management activities. Since we do not have all the elements at this point in time to validate the proposals in the ED, it is our belief that interested constituents should be given the opportunity to make a final assessment of the whole revision of the hedge accounting rules, including macro hedging. Because of this, we strongly urge the Board not to finalise a standard on the general hedge accounting model until a macro hedging model is developed.

(b) Lack of Clarity Regarding the Borderline between Risk Management and Hedge Accounting

The main proposal in the ED is to adopt a principle-based approach that will align hedge accounting more closely with the risk management strategies undertaken by an entity when hedging its risk exposures. As we have mentioned above, we support this principle-based approach.

However, it is unclear from the ED where the borderline between risk management and hedge accounting is. Pending further clarifications in the final standard, we foresee a situation where diversity in practice in the application of hedge accounting would likely arise.

Take a simplistic example for illustration: an entity gives a 5½-year fixed rate loan to a customer which is classified at amortised cost. At the same time, the entity enters into an external 5-year payer swap. The entity's risk management considers this to be an appropriate hedge and is prepared to accept the slight

ineffectiveness arising from the mismatch in maturities between the loan and the payer swap. Two interpretations could arise due to the above-mentioned lack of clarity:

Interpretation 1: There is no differentiation between risk management and hedge accounting.

In other words, the hedge undertaken by the entity's risk management is designated as it is for hedge accounting. Hence, this hedge would create ineffectiveness in the financial statements due to the mismatch in maturities.

— Interpretation 2: There is a differentiation between risk management and hedge accounting.

The hedge undertaken by the entity's risk management forms the basis. However, from a hedge accounting perspective, an optimal hedge ratio is determined whereby only a portion of the hedged loan is designated against the entire hedging instrument. The determination of this optimal hedge ratio is only for accounting purposes to support the proposed hedge accounting qualifying criteria in paragraph 19(c) of the ED, i.e. to produce an unbiased result that minimises hedge ineffectiveness and to achieve other than accidental offsetting.

— We read the ED as referring to Interpretation 2. In this case, the term “minimise” would suggest that only an expected offset of 100% would suffice, which would be a higher standard than is currently contained in IAS 39. Furthermore, we interpret the ED as demanding that the **accounting hedge ratio** in our example above to mandatorily deviate from the **risk management hedge ratio**, even though the expected ineffectiveness ought to be tolerable. We support this provided that to achieve the ED's stated objective of lessening the burden of applying hedge accounting, less strict wording for the qualifying criteria is used, e.g. “produce a result that captures the essence of the hedge relationship and avoids unreasonable ineffectiveness”.

— The unclarity in the ED on this issue is further compounded by the ED usage of concepts like hedge ratio, net positions, nil net positions, certain aggregate exposures that are combinations of exposures and derivatives, and rebalancing a relationship's hedging instruments and hedged items. These concepts are commonly used within a risk management environment. In the light of this, we recommend that the IASB provides clarification on this in the final standard.

(c) Objective to Align Hedge Accounting with Risk Management

Although we support the overall direction in the hedge accounting objective to align with risk management, we believe that so long as core hedge parameters used by a bank's risk management strategy are proposed or continued to be prohibited in the ED, it is questionable whether the desired objective is achievable. These core hedge parameters are:

- Banks hedge the net risk exposure resulting from financial assets and financial liabilities;
- Banks incorporate modelled transactions as part of their hedged items e.g. core deposits;

- Banks hedge using internal derivatives; and
- Banks hedge with the objective of keeping the resulting risk exposure within pre-defined risk limits set by top management.

(2) Specific Proposals

(a) Prohibition of Internal Derivative Contracts as Eligible Hedged Items

As with IAS 39, the ED continues to mandate that internal derivative contracts are not allowed for designation as hedging instruments.

Commerzbank has implemented a group wide centralised Treasury function that manages the Group's interest rate and liquidity risks. If Treasury wishes to hedge an exposure to a particular risk (e.g. interest rate risk), it almost always does so by entering into an internal derivative with the centralised trading department. The latter then hedges its net risk with external counterparties. Our risk management policy gives internal hedges priority over direct hedges with external counterparties as this significantly enhances economic efficiency by minimising hedging costs, minimising counterparty credit risk exposure and making use of in-house expertise.

Currently, hedge accounting under IAS 39 does not make it an objective to reflect an entity's risk management strategies in its financial statements. However, the ED now introduces a hedge accounting objective to represent in the financial statements the effect of an entity's risk management activities when using financial instruments to manage risk exposures. Our view, as we have mentioned earlier, is that prohibiting internal derivatives as hedging instruments makes the proposed hedge accounting objective in the ED to align hedge accounting with risk management non-achievable, since it is inconsistent with common risk management practice. On the contrary, we strongly believe that internal derivatives should be eligible for hedge accounting due to the following reasons:

- The use of internal derivatives reflects an entity's structure and risk management process, and provides the link between the risk exposures and how the risk exposures are transferred externally.
- For risk management purposes the original hedging relationship is often assessed based on the internal hedges. However, in allowing only external derivatives in the application of hedge accounting, this creates a high level of uncertainty towards applying paragraph B38 of the ED ("An entity's risk management is the main source of information to perform the assessment whether a hedging relationship meets the hedge effectiveness requirements").
- It is our opinion that high quality accounting standards should reflect the practice of doing business in an entity, and not that an entity changes its business practice to adapt to accounting requirements. This is consistent with the IASB's decision to incorporate the role of the business model in the classification of financial instruments (Phase 1 of the IAS 39 Replacement Project) including the

direction undertaken by IASB in the ED's hedge accounting objective to reflect the extent and effects of an entity's risk management activities in its financial statement.

In the event that internal derivative contracts continue to be prohibited, an entity would have to continue with the current practice of artificially designating external derivative contracts that are not related to the entity's risk management strategy. In this circumstance, the ED should make clear that this is only to fulfill accounting requirements. Consequentially, it is our view that the proposed enhanced disclosure requirements in the ED to address the concerns of financial statement users would not be meaningful since the original source of information that risk management uses to actively manage the targeted hedged risk is often based on the internal deals. This is in addition to the fact that preparers of financial statements would find it difficult and onerous to fulfill the proposed disclosure requirements.

(b) Prohibition of Voluntary Discontinuation of Hedge Accounting

In today's application of hedge accounting, an entity that adopts an internal risk management policy of using internal derivatives overcomes this restriction by installing a process to search for the best available external derivatives that match the internal risk exposure to designate as the hedging instruments. Current hedge accounting under IAS 39 also allows an entity to discontinue hedging relationships voluntarily.

In the case of our open-portfolio macro hedging, Commerzbank uses the option to discontinue (and then re-designate) in its application of IAS 39's *Portfolio Fair Value Hedge of Interest Rate Exposure* for the following reasons:

- To reflect the changes in risk exposures whereby the hedging items and hedging instruments that make up the hedging relationships often undergo frequent changes;
- To change the make up of external derivatives that are designated instead of the internal derivatives; and
- To meet the tight effectiveness assessment bright line of 80% - 125%.

The motives to de-designate voluntarily due to changes in risk exposures and the effectiveness assessment bright line are essentially a result of the strict current hedge accounting qualification criteria and the deficiency of the current macro hedge accounting model in IAS39 as it was designed to replicate dynamic hedging strategies based on closed portfolio logic for accounting purposes. The relaxation of the effectiveness assessment threshold as proposed in the ED is an amicable solution. The solution to the other motive would primarily depend on the direction the Board is taking in its subsequent exposure draft on macro hedging. Given the importance of macro hedging to Commerzbank and the banking industry, we strongly urge the Board to uphold its commitment to align risk management and hedge accounting by

considering seriously the various banking issues on macro hedging when proposing an appropriate model for macro hedging.

In contrast, the need to change the make up of designated external derivatives is a direct consequence of the accounting standard to prohibit internal derivatives from being designated in hedge accounting, despite the economic reality of the entity's risk management activities.

When the ED proposes to prohibit voluntary discontinuation of hedging relationships that still meet risk management objective and strategy (to be consistent with the new hedge accounting objective to align risk management activities with hedge accounting) while at the same time retaining the prohibition on internal deals, a new complexity arises. The consequence of this new complexity is that it would be very difficult to operationalise hedge accounting. This adverse consequence persists as long as internal derivatives continue to be disallowed for hedge accounting. We therefore recommend that the current permission in IAS 39 to discontinue hedge accounting voluntarily be carried forward into the final standard.

(c) Sub-LIBOR Issue

The ED retains the IAS 39 mandate that an entity cannot designate a portion that is bigger than the total of the cash flows of the hedged item. The retention of this restriction has serious consequences for entities, in particular banks that have interest-bearing financial instruments that are priced at sub-LIBOR. In accordance with the restriction requirement, the LIBOR component remains ineligible for designation in hedge accounting.

We do not support the ED's retention of this restriction requirement for the following reasons:

- Banks, in their risk management strategies, are not attempting to hedge the effective interest rate of the financial instruments as stipulated in the ED. Instead, banks' aim is to manage the interest rate risk exposure by locking in the *margin* of an asset or liability over the life of the hedge. By definition, this implies that one cannot judge a hedge's effectiveness in achieving this objective by looking at an asset or a liability in isolation (as the IASB does in Staff Paper 16, Example 1). Rather, one has to look at the asset in conjunction with its funding or the liability in conjunction with its investment. If one looks at the complete picture, it is quite obvious that the hedge objective – stabilizing the margin – could be achieved independent of the fact whether the hedged item bears an interest rate that is above or below LIBOR.
- It is common risk management practice that banks use standardised hedging instruments that bear LIBOR when carrying out their hedges. Since the ED's hedge accounting objective is to align risk management activities with hedge accounting, not allowing banks to designate the sub-LIBOR component is not reflective of their risk management strategy. In our view this creates inconsistency between risk management practices and the ED's hedge accounting objective. In the end, users of fi-

nancial statements are being penalised by including this non-useful information in the financial statements.

- The sub-LIBOR issue is particularly relevant in the case of deposits, where banks commonly have access to sub-LIBOR funding. The negative spread represents a positive margin for the bank and it is common risk management practice to use sub-LIBOR deposits as hedged items, explicitly in order to hedge this margin.

We strongly urge the Board to consider allowing sub-LIBOR instruments to be eligible for hedge accounting.

(d) Hedge Accounting for Hedges of Credit Risk

In contrast to IFRS, the US generally accepted accounting principles (SFAS 133.411) has specified credit risk as one of the 4 types of risk that qualify for hedge accounting. Although the current version of IAS 39 does not contain such a list of qualifying risks for hedge accounting, credit risk is permitted in general to be designated as a hedged risk provided it is reliably measureable and separately identifiable (risk components designation criteria).

The ED retains the current IAS 39's principle-based logic of not specifying a list of risks that qualify for hedge accounting, while at the same time retaining the designation criteria for risk components. However, the Board has opined in its Basis for Conclusions that hedges of credit risk using credit default swaps would not meet the 2 risk components designation criteria. The reason given by the Board is that the spread between the risk-free and market interest rate incorporates components other than credit risk (i.e. liquidity, funding and any other unidentified risk components), and hence it is operationally difficult (if not impossible) to isolate and measure the change in fair value attributable to the credit risk.

However, the opinion expressed by the Board in its Basis for Conclusions is not within the objective of developing principle-based accounting standards since it circumvents this objective by imposing a rule to prohibit specific risk components. On the contrary, we believe that an entity should be permitted to apply hedge accounting for hedges of credit risk (or for other types of risk components) so long as the entity is able to meet the qualifying criteria. There is no rationale to limit the component risk approach to credit risk since there is no difference to the accepted logic in current hedge accounting application of using the benchmark swap curve for hedges of interest rate risks. Taking this same logic for hedges of credit risk, the credit spread curves could be extracted from the CDS markets. Therefore, we consider the opinion given by the Board in the Basis for Conclusions to be inappropriate and we recommend that the Board either eliminates the opinion or tone down the opinion so that it is not perceived to be a rule that disqualifies credit risk from hedge accounting. Besides, doing this would not prematurely terminate a development that is currently taking place and that strives to establish that credit risk could meet the

qualifying criteria for hedge accounting application. It is our belief that this development should be given the chance to be brought to fruition.

At the same time, we acknowledge that an accounting alternative should be in place when an entity fails to meet the qualifying criteria to apply hedge accounting for hedges of credit risk. Hence, we support the efforts by the IASB to investigate further the development of the proposed accounting alternatives to hedge accounting and Fair Value Option. For the reasons mentioned in our answer to Question 15, we are in support of Alternative 3, despite its complexity, since it best reflects the effects and extents of the credit risk mitigation strategies that are undertaken by banks in their management of credit exposure using credit derivatives.

Our detailed responses to the questions posed in the invitation to comment are included in the Appendix to this letter. Our views expressed in this comment letter may be subject to change at a later stage when we get a more complete picture, including the other phases in the project to replace IAS 39 which we view to be interconnected.

We thank the Board for considering our comments and would be pleased to meet with the Board or its staff at your convenience to discuss our concerns raised in this comment letter.

Kind regards,

COMMERZBANK
Aktiengesellschaft



Joerg Hessenmueller
Head of IB Finance



Dr. Patrick Kehm
Head of Accounting Principles

Appendix

Q1.

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

Currently, IAS 39 does not contain a stated objective for hedge accounting. Today application of hedge accounting gives rise to arbitrary results in the financial reports that do not reflect the economic consequences of the hedging activities undertaken by an entity. This is because hedge accounting under this circumstance is primarily used to eliminate or reduce accounting mismatches in profit or loss that arise from the use of derivatives as hedging instruments in the hedging activities.

In the light of the above inadequacy of today's hedge accounting model, we agree with the IASB's move to closer align hedge accounting with risk management activities. We believe that this fits into the overall picture of having principle-based standards within the IFRS Framework in that high quality accounting standards should reflect the practice of doing business in an entity. The proposed objective is also consistent with the Board's decision to include the role of an entity's business model in the classification of financial instruments. Overall, the proposed objective allows a more transparent representation of the impacts of hedging activities on the entity's economic well-being.

At the same time the ED retains the requirement that the application of hedge accounting is not mandatory but rather based on voluntary designation. We agree with this as the mandatory application of hedge accounting would put undue heavy burden on the reporting entity, such as the operational challenges to identify all risk management strategies that would qualify for hedge accounting and hence would have to be shown in the financial reports.

However, we are doubtful whether the move to closer align hedge accounting with risk management activities could be achieved, considering that there are a number of proposals in the ED which prohibit banks from applying hedge accounting for their hedges although their use are common and well integrated in sound risk management practice. These restrictive proposals in the ED contradict the principle of installing quality standards that reflect the way an entity carries out its business activities including the business model it adopts:

- Internal derivative contracts are not eligible to be designated as hedging instruments.
- Recognising that risk management undertakes hedges on net positions, but when it comes to hedge accounting the designation of hedged items constituting the net positions must be on a gross basis.
- Disallowing the designation of a portion that is bigger than the total cash flows of the hedged items (the so-called sub-LIBOR issue).

- Failure to recognise risk management hedge objective of keeping resulting risk exposure within pre-determined risk limits.

At the same time, we are concerned about the lack of clarity on the borderline between risk management and hedge accounting. We understand that risk management strategy and activity are the starting points. But, it is not clear from the ED to what extent they are incorporated into hedge accounting for designating the hedging relationships, deciding on the hedge ratio, re-balancing the designated hedging relationships subsequently etc. This lack of clarity is further compounded by the ED usage of concepts, such as hedge ratio, re-balancing and net positions, that are commonly used within risk management environment.

Lastly, we do not agree with the restriction to limit hedge accounting only to risks that affect profit or loss. Risks that affect other comprehensive income (OCI) are therefore prohibited. As a result, equity investments that an entity has opted to classify under IFRS 9 as at fair value through OCI are ineligible to be designated as hedged items for hedge accounting, should the entity decide to hedge subsequently the price risk for economic reason using derivatives as hedging instruments. We find this is not consistent with the proposed overall aim, which we support, to align hedge accounting with risk management activities. Furthermore, the resulting accounting mismatch is a direct consequence of the classification decision taken by the IASB Board for equity investments in IFRS 9. Entities are now being penalised for undertaking such a hedging strategy although it makes economic sense. Hence, it is our belief that economically sound hedging strategies that involve equity investments should not be precluded from hedge accounting.

Q2.

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 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 for the following reasons:

- The consideration of whether a financial instrument is eligible as a hedging instrument for hedge accounting purposes should be based on the risk management objective and the strategy chosen to achieve that objective. Hence, if non-financial instruments are used by risk management in its hedging activities, they should qualify as hedging instruments for hedge accounting purposes. This is consistent with a principle-based accounting standard, and supports the overall objective to align an entity's risk management activities with hedge accounting.
- It is consistent with the classification model of IFRS 9 for those non-derivative financial instruments that are required to be classified as at fair value through profit or loss.

Q3.

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 agree with the ED's proposed approach to allow a synthetic exposure (i.e. a combination of non-derivative instrument and a derivative) to be designated as a hedged item. We support this proposed approach as it meets the ED's proposed hedge accounting objective to align hedge accounting with risk management activities. Permitting this therefore enables an entity to provide information that is vital to users of financial reports, such as how it manages the targeted hedged risks and to what extent the hedging strategies affect the economics of the underlying transactions.

However, the consequences of this proposal require clarification when addressing macro hedging in the 2nd part of the hedge accounting phase. From a risk management perspective, the exposure under macro hedging is managed as a whole, regardless of whether the exposure arises from cash positions or previous hedging derivatives. Therefore, the application of the proposal in the ED in the context of macro hedging could give rise to complexity as banks would have to determine the layer of synthetic exposure to designate.

Q4.

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?

Commerzbank, similar to other banks, often pursues risk management strategies that focus to hedge separately individual risk components present in an underlying transaction. Hence, permitting an entity to designate a risk component as the hedged item in a hedging relationship is in line with the proposed hedge accounting objective to facilitate closer alignment of the accounting treatment with risk management practices.

However, we oppose the decision of the IASB to include rules or conclusions in the ED. We believe that they contradict the primary purpose of formulating a principles-based approach to setting accounting standards:

- In the Basis for Conclusions, the IASB Board has concluded that it is operationally difficult (if not impossible) to isolate and measure the credit risk component of a financial item that meets the

“separately identifiable and reliably measureable” eligibility criteria. The inclusion of such opinion in the Basis for Conclusion contradicts the aim of formulating accounting standards that are based on principles rather than rules. At the same time, such opinion could potentially set precedent and automatically disallow an entity the ability to designate the credit risk component of financial item due to the inability to satisfy the 2 qualifying eligibility criteria in paragraph 18(a). In view of this, we strongly recommend that they are removed or tone down so that it is not perceived to be a rule that disqualifies credit risk from hedge accounting. We have made further comments on the subject of accounting treatment for credit risk hedging using credit default swaps (CDS) in Question 15.

- We understand the principle formulated by IASB in paragraph B15 that a contractually specified risk component is strong evidence that the 2 qualifying eligibility criteria in paragraph 18(a) are satisfied, in comparison with a non-contractually specified risk component. Hence, an entity needs not provide further proof when it comes to contractually specified risk components. However, in paragraph B18 when it comes to an inflation component of a financial instrument we are concerned with the rule-based approach that precludes the inflation component from being designated as a hedged item unless it is contractually specified. We strongly recommend that the IASB remove this rule-based requirement. Also we fail to understand the conceptual reason behind the Board’s decision to limit this prohibition to financial instruments and not to apply it to non-financial instruments as well, considering that the aim of the Board is to have consistent hedge accounting requirements for designating risk components as eligible hedged items that apply to both financial and non-financial instruments.

Last but not least, we disagree with the ED’s continued prohibition in paragraph B24 to disallow a portion of cash flows of a financial instrument as the hedged item when that portion is larger than the total cash flows of the instrument (the so-called “sub-LIBOR issue”), a point which we have elaborated on in our cover letter.

Q5.

- (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?**

We agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item. This proposed alternative way of designating the hedged item (other than the percentage hedge designation) meets the hedge accounting objective stated in the ED. It allows a closer alignment with the type of risk management strategy where the intention is to hedge a targeted layer of the underlying transaction due to the uncertainty faced by the entity surrounding its timing or amount. This uncertainty could arise from the nature of the transaction (e.g. an anticipated issuance of a bond offering in 6 months time) or the presence of a prepayment option in the transaction. This targeted hedged layer is

identified using business methods and modelling techniques that are well accepted and based on sound risk management practices. We believe that this proposal will eliminate a significant issue for entities engaging in such a layer component hedging strategy, thus reflecting an accounting outcome in the financial reports that is consistent with these banks' risk management objectives. This in turn provides useful information for users of financial reports.

This proposal should be carried forward to macro hedging, the focus of the planned 2nd exposure draft by the IASB, since banks often employ layer component hedging to replicate the uncertainties inherent in their open portfolios of financial assets and financial liabilities.

Q5.

(b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?

We consider the proposal appropriate only for hedges of single items. However, in the case of hedges involving portfolios (closed or open), we consider this proposal to be inappropriate. It is accepted risk management practice in the banking industry that the prepayment options present in a portfolio of financial instruments are replicated into layers, using well-known modelling techniques that are based on the behavioural patterns that customers exhibit when making prepayment decisions. The identified stable layer in the portfolio is then targeted in the banks' hedging strategy since this stable layer behaves similarly to any other fixed rate or floating rate loan or deposit. This risk management practice has the support of supervisory authorities and the Basel Committee.

Q6.

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?

Under IAS 39, the hedge effectiveness requirements are met when the hedging relationship is expected to be highly effective, both prospectively and retrospectively, where the extent of the offset of the changes in fair value or cash flows attributable to the hedged risk is within the range of 80% to 125%. We support the IASB's decision to eliminate these strict rule-based hedge effectiveness requirements which often disqualify an entity from applying hedge accounting, and hence prevent the entity from presenting its risk management activities in the financial reports. At the same time, we also support the following move in the ED:

- To replace the current hedge effectiveness assessment in IAS 39 with an objective-based assessment that enhances the alignment between hedge accounting and an entity's risk management activities.
- To perform only the hedge effectiveness assessment prospectively at the inception of the hedging relationship and at each reporting date or upon a significant change in the circumstances affecting the hedging relationship.
- ○ Not to specify a particular assessment method.

Under IAS 39, the bright-line 80%-125% effectiveness test determines which hedging relationships undertaken by risk management are ultimately designated as hedging relationships for hedge accounting purposes. In removing the bright-line 80%-125%, the ED now proposes new qualifying criteria - the hedging relationship needs to produce an unbiased result and is expected to minimise expected hedge ineffectiveness and to achieve other than accidental offsetting - that an entity has to meet in order to apply hedge accounting. To meet these new qualifying criteria, the ED has introduced a "hedge ratio" concept.

However, it is very unclear in the ED whether this "hedge ratio" is defined from a risk management perspective or from an accounting perspective. This unclarity is more significant given that the ED's proposed new hedge accounting objective is to align hedge accounting with risk management activities. In spite of this, we interpret the hedge ratio in the ED to be an *accounting hedge ratio*. Hence, even though risk management has entered into a hedging relationship where it accepts a tolerable level of expected ineffectiveness, the ED would require the entity to determine an optimal hedge ratio for accounting purposes to meet the new proposed qualifying criteria for hedge effectiveness assessment. We request the IASB to clarify its intention in the final standard. Despite this, we are concerned with the potential complexities that could arise:

- ○ A disconnect between hedge accounting and risk management is still possible especially in situations where risk management has undertaken hedges for which a certain level of ineffectiveness is accepted, e.g. because the resulting risk stays within certain risk limits. In such situations the ineffectiveness reflected in the financial reports based on the accounting hedge ratio might not be useful for financial statement users as they would not be able to assess the effectiveness of the hedging strategies undertaken by an entity's risk management.
- An entity would have to set up a new process to determine whether the hedging relationships entered into by its risk management are optimal in order to meet the proposed qualifying criteria. Furthermore, the entity could be asked to provide supporting evidence that the hedge ratio that is ultimately designated is the optimal one for auditing purposes.

- The term “minimise” used in the proposed qualifying criteria would suggest that only an expected offset of 100% would suffice. This would be a higher standard than what is currently contained in IAS 39.

In order to achieve the ED’s stated objective of lessening the burden of applying hedge accounting, we suggest to use less strict wording for the qualifying criteria, e.g. “produce a result that captures the essence of the hedge relationship and avoids unreasonable ineffectiveness”.

Lastly, paragraph B38 requires an entity’s risk management to be the main source of information to perform the hedge effectiveness assessment. When internal derivative contracts are used in risk management activities, an entity is required to search and designate external derivatives instead for hedge accounting. However, when assessing, measuring and reporting the effectiveness of the hedging strategy to top management, the entity’s risk management often uses information derived from the internal derivatives. Hence, the entity would face an operational challenge in fulfilling the requirement in paragraph B38. We believe that this inconsistency would introduce unnecessary complexity in hedge accounting and would conflict with the proposed hedge accounting objective to reflect in the financial statements the entity’s risk management activities. Hence, we strongly recommend that the Board reconsider how internal deals could be incorporated into the proposed hedge accounting model.

Q7.

(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?

As we read the ED, adjustments to original hedging relationships (rebalancing) could arise in 2 situations:

- Adjustments that are driven by risk management activities and taken up for hedge accounting exactly as they are as they fulfil the proposed hedge effectiveness assessment objective. For example, an entity’s risk management enters into a FX basis hedge with a hedge ratio of 0.8. The basis spread changes a week later and the entity’s risk management decides to adjust the hedge ratio from 0.8 to 0.85 to improve the hedge results. Hedge accounting rebalances the same 0.85 hedge ratio that risk management uses.
- Adjustments that are driven by hedge accounting which itself differs from the risk management. Using the same example as above, risk management decides not to adjust the hedge to the new hedge ratio of 0.85 because it is within its risk limits. However, for hedge accounting purposes, the hedging

relationship needs to be rebalanced to the new hedge ratio of 0.85 in order to fulfill the proposed new hedge effectiveness criteria.

In the case of rebalancing in the 1st situation, we believe rebalancing would facilitate the proposed hedge accounting objective in the ED because it allows accounting to treat the changes in hedging relationships, similar to risk management, as a continuation of the original hedging relationship, and hence avoids the possibility of a disconnect between hedge accounting and risk management.

However, as we have mentioned in our response to Question 6, we interpret the hedge ratio concept formulated in the ED to be an accounting hedge ratio. As a consequence, we therefore read the rebalancing concept in the ED to be the one arising in the 2nd situation above. Furthermore, in assessing whether to rebalance or not for accounting purpose, an entity needs to consider paragraph B50 (i.e. is it a fluctuation around a continuing trend and hence no rebalancing is needed or is it an indication of a new trend and hence rebalancing is needed).

We believe that the intentions behind the rebalancing concept are good (such as eliminating illogical hedge accounting effects from being reported in the financial reports because the hedge documentation fails to envisage the adjustments that risk management could make during the hedge period), and that they help to align risk management with hedge accounting. However, we believe that the rebalancing concept as envisaged in the ED, i.e. from an accounting perspective, could give rise to potential new complexities and problems that we have highlighted in our response to Question 6.

Furthermore, the ED requires that on rebalancing the hedging relationship for hedge accounting purposes, the hedge ineffectiveness of the hedging relationship should be determined and recognised in profit or loss immediately before adjusting the hedging relationship. Our view is that this would create unnecessary and artificial volatility in profit or loss.

Q7.

(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?

From an accounting perspective, we agree that an entity should be allowed to rebalance a hedging relationship voluntarily when it expects not to meet the objective of the hedge effectiveness assessment. This complements the proposed hedge accounting objective as it makes the link stronger between hedge accounting and risk management.

However, as we have mentioned in Question 7 (a) above, we are concerned with potential new complexities that come with the application of the concepts proposed in the ED.

Q8.

(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?

We agree to the principle that hedge accounting should be discontinued when the hedging relationship ceases to meet certain qualifying criteria. However, as we have explained in our responses to Questions 6 and 7, we have concerns about new complexities that might arise due to the proposed qualifying criteria specified in the ED, especially when the application of the accounting concepts like hedge ratio and rebalancing gives rise to a disconnect with risk management activities.

Q8.

(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?

We do not agree for the following 2 reasons:

Internal Derivative Contracts

Our risk management enters into hedging relationships by transacting internal derivatives with the trading department, who in turn passes the risk on a net basis to external counterparties (after taking into consideration its approved risk limits). To go around the prohibition to designate internal derivatives, we have to search and designate the best matching external derivative against the hedged item in the hedging relationship. We require the ability to discontinue voluntarily hedge accounting for hedging relationships when the internal derivative that is involved in the hedging strategy is terminated by the risk management, but the external derivative designated for hedge accounting continues to exist. However, this problem would no longer exist if internal derivatives were allowed to be designated for hedge accounting.

Macro Hedging

More importantly for us, the ability to discontinue voluntarily is of particular importance in the 2nd part of the hedge accounting phase on macro hedging. In macro hedging our risk management pursues a dynamic hedging strategy where the underlying transactions and the hedging derivatives that are included in the open portfolio are continuously changing over time, even on a daily basis. To cope with the dynamic composition of the open portfolio, it is our belief that an entity should be permitted to voluntarily discontinue hedge accounting in order to reflect the effects and the extent of our risk management activities in the financial reports. As we have yet to see the direction the Board would be taking on macro hedging, we are therefore very concerned about this aspect of the proposal.

Q9.

(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?

Compared to the earlier tentative decision by the Board to replace fair value hedge accounting mechanics with the cash flow hedge accounting mechanics, we support the ED's proposal 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. This proposal is definitely superior for the following reasons:

- It does reflect the type of risk management strategy in the financial reports that is used by the entity, namely the fair value hedges.
- It does not cause artificial volatility in other comprehensive income (OCI).
- It does not lead to negative equity (whereas the earlier tentative decision would have).

We understand that the proposed fair value hedge accounting mechanic in the ED would resolve the difficulties faced by users of financial statements like analysts in understanding and assessing the effects and impacts of risk management activities reflected in the financial reports through the use of hedge accounting.

However, we acknowledge that the 2-step approach (fair value changes of the hedge are first recognised in OCI and the ineffectiveness is subsequently transferred to profit or loss) would create additional operational complexity for preparers of financial statements, without increasing the information value to users. This is because each of the 3 line items presented in the OCI is the sum of all hedging transactions and hence would not enable users to determine the effectiveness of the entity's particular risk

management strategy. Hence, as an alternative, we believe that this information could be better given in the disclosure notes rather than in the primary financial statements.

Q9.

(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?

We agree to the separate line item presentation in the balance sheet for fair value hedge accounting mechanics as this would lead to greater transparency and help the users to better understand the financial statements. At the same time, it would avoid adjusting the carrying amount of the hedged item for the gain or loss attributable to the hedged risk, thus preventing a complication for the mixed model by having financial instruments on the balance sheet that are neither amortised cost nor fair value.

However, we find that the proposal to have a separate line item in the balance sheet adjacent to the line item that contains the hedged asset or liability would increase operational difficulties for preparers and reduce understandability for users of financial statements. This happens when an entity increases the number of hedging relationships involving many different types of assets or liabilities or when an entity's hedging strategies increase from simple hedging relationships to macro hedging, thus causing a substantial increase in the number of separate line items on the face of the balance sheet. Due to this we recommend that the aggregated net amount of all fair value hedge adjustments from all hedged assets or hedged liabilities are presented as a single line item on the balance sheet, i.e. the single line item is shown on the asset side when the aggregated net amount is a debit balance or on the liability side when the aggregated net amount is a credit balance. To allow users of financial statements to identify the hedged items and the associated gains or losses, appropriate disclosures could be made in the notes.

Q9.

(c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

We agree that linked presentation should not be allowed. Such information could be better given in the notes to financial statements. Besides using a linked presentation would be inappropriate, complex and confusing when an entity engages more complex hedging transactions such as macro hedging.

Q10.

- (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 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 perfect match the hedged item)? Why or why not? If not, what changes do you recommend and why?**

We welcome the accounting treatment proposed in the ED for the time value of an option when an entity designates, for hedge accounting, only the intrinsic value of the options used in the entity's risk management activities. We agree to the logic of treating the time value of an option as a cost to the entity for undertaking the hedge (either as part of a transaction cost or as an insurance cost depending on the nature of the hedged item) as this represents more closely the rationale behind the risk management strategy that uses options as hedging instruments. This would avoid the volatility in profit or loss arising from changes in the time value of the option, as it is currently the case under IAS 39.

Although we agree to the conceptual reasoning behind the different methods to reclassify the amount accumulated in OCI, we note that the proposals could introduce potential complexities for both the preparers and users of financial statements. However, we acknowledge that this is a necessary consequence unless a single approach could be achieved to minimise the potential complexities.

Q11.

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?

Our risk management activities only comprise dynamic hedges of open portfolios (macro hedging). Hedges within a closed portfolio environment are never utilised. At this moment, we are unclear about the Board's direction with respect to macro hedging, the 2nd part of the hedge accounting phase.

In general we support the direction taken by the ED to permit groups of items to be eligible for hedge accounting provided the group of items is managed together for risk management purposes. This alignment to risk management activities is extended to groups where the net position is hedged.

However, we are concerned with some of the restrictions in the proposed model for closed groups of hedged items that could affect the Board's discussion on macro hedging:

- A net position remains ineligible to be designated as the hedged item for hedge accounting. Even though an entity hedges the net exposure on a net basis for risk management purposes, the entity could only designate the total gross amounts of assets and liabilities that together give rise to the hedged net position for hedge accounting purposes. Although it attempts to establish a link to risk management, it falls short of what risk management is actually doing.
- The restriction that allows an entity to designate the LIBOR component of the interest rate as the hedged item only if the cash flows that relate to the LIBOR component are less than the total interest cash flows of the financial instrument (the "sub-LIBOR issue"), which we have elaborated on in our cover letter.

Q12.

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 item? Why or why not? If not, what changes do you recommend and why?

We agree that for a cash flow hedge of a group of items with offsetting risk positions that affect different line items in the income statement, the gain or loss reclassified from OCI should be presented in a separate line item. This would avoid artificial grossing up of gains or losses that do not exist.

However, we are concerned about the presentation proposal in the ED for groups of items in a fair value hedging relationship, where the gains or losses on the assets or liabilities would be recognised in the balance sheet as they would be for one-to-one hedging relationships. In other words, the gains or losses on each item in the group would be presented on a gross basis next to each line item that includes the related asset or liability. As we have explained in our response to Question 9, we believe this presentation proposal would introduce new complexity for preparers of financial statements and increase the difficulty in understanding financial reports for users. For these reasons, we have recommended in Question 9 a single line item on the balance sheet that contains the aggregated net amount and to make disclosures on the details of the aggregated net amount.

Q13.

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

We view disclosures to be an integral part of principle-based accounting standards, and that they are necessary to increase transparency and comparability. The aim of the proposed disclosures is to allow users to understand those risk management activities that qualify for – and are elected by the entity to be documented as – hedge accounting.

We believe the above proposed aim of the disclosures fits a risk management environment where only external hedging derivative are used. However, in a risk management environment where it is common practice to use internal hedging derivatives, we believe that the above proposed disclosures would not be achievable, and would anyway be difficult to implement. As we have mentioned in our answers to some of the questions above, we do not support the Board's prohibition of internal derivative contracts to be eligible as hedging instruments for hedge accounting as this is inconsistent with the proposed objective to align hedge accounting to risk management activities and to reflect the effects of hedging in the entity's financial reports.

Having said that, we are also concerned about the prescriptive nature of the proposals, in particular the proposals to provide, in a tabular format, information on the hedging instrument, the hedged item and the changes occurring during the reporting period. We find this to be inconsistent with the goal of developing principles-based standards.

Moreover, we understand that the IASB has designed the proposed disclosure requirements to address the concern expressed by financial statement users that they do not find the current hedge accounting disclosures helpful. However, we believe that the proposed disclosure requirements are onerous and very difficult for entities to prepare without adding information for users of financial statements. This is in particular true for entities that use internal derivatives in their hedging strategies. Their management evaluates and makes decisions using information that are produced from these internal derivatives.

Q14.

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?

Not applicable.

Q15.

- (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 believe that the opinion expressed by the Board in its Basis for Conclusions – that it is operationally difficult (if not impossible) for credit risk hedges to meet the 2 qualifying criteria for designating risk components – is inappropriate and not in the spirit of developing principle-based accounting standards. Hence, we recommend that the Board either eliminates or tones down the opinion so that it is not perceived to be a rule that disqualifies credit risk from hedge accounting prematurely.

We understand that there are efforts undertaken by certain parties in the market to develop a methodology to isolate and measure the changes in fair value that are attributable to credit risk for the purpose of hedge accounting. Our view is that such efforts should be supported and be given the chance to be brought to fruition. The prime supporting argument is that for hedges of interest rate risk using interest rate swaps, IFRS and US GAAP allow the hedged fair value changes to be measured by referencing to the benchmark swap curve. Hence, the discount rates used for pricing the swaps are the same as those used for pricing the debt instruments for hedge accounting purposes. This logic could be applied similarly for credit risk. The credit spread curves are extracted from the CDS markets and are then used in determining discount rates that keep all other risk factors except for credit risk constant when calculating the fair value change of the debt instrument's cash flows. In both cases (interest rate risk hedges and credit risk hedges), an entity would be right in neglecting the price changes resulting from other market factors for hedge accounting purposes.

However, we acknowledge that an accounting alternative should be available at the same time, and hence appreciate the efforts made by the IASB in this regard. We consider that all 3 alternatives considered by the Board to account for credit hedges using credit derivatives would add complexity to the accounting for financial instruments. Nevertheless, we believe that Alternative 3 achieves the best trade off between the added complexity and the benefits of solving this long-term issue for banks. At the same time, Alternative 3 provides useful information in the financial reports about the effectiveness of the credit risk mitigation strategies undertaken by banks:

- It better reflects the effects and the extent of the credit risk mitigation strategies undertaken by banks in their risk management of credit exposure using credit derivatives, especially when compared to the Fair Value Option.
- It eliminates the illogical results that are caused by the marking-to-market of the credit derivatives, results that differ from the economic reality of the credit risk mitigation strategies undertaken.

Q16.

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 ED that the final standard should be applied prospectively as this is in line with the hedge accounting proposals that hedging relationships could only be designated prospectively.

We also support the proposal that hedging relationships would be regarded as continuing on effective date when they qualify for hedge accounting in accordance with IAS 39 as well as under the final standard. However, we are unsure how this proposed requirement would be handled under macro hedging considering its dynamic nature and that we currently do not know the direction the Board is taking for macro hedging.

However, we do not agree to the proposal to permit early adoption, even under the restriction that early adoption is allowed only when all requirements under IFRS 9 including impairment are adopted at the same time. The reason for our disagreement is that this would give rise to incomparability of financial statements of companies for users.

As we have mentioned in our comment letter to the Board's Request for Views published in October 2010, we have recommended that all standards included in the Request for Views should have 01.01.2015 as their common effective date. This is based on the assumption that the Board completes all of these projects by 30.06.2011, including the part on the hedge accounting model for macro hedging, and that the EU endorses these standards by 31.12.2011.