



BNP PARIBAS

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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Comments on Exposure Draft on *Hedge Accounting*

Dear Sir or Madam,

We are writing to comment on the *Hedge Accounting* exposure draft issued by the IASB on December 9, 2010. This exposure draft is the first part of IFRS 9 phase 3. Its purpose is to set a general model for hedge accounting applied to individual items and closed portfolios. An additional exposure draft is expected in Q2 2011 for hedge accounting of open portfolios or macro hedging.

Compared to IAS 39, the hedge accounting model proposed by the IASB is a significant improvement in terms of objective: hedge accounting is expected to better represent the effect of an entity's actual risk management activities in the financial statements: the new approach is more judgemental and principle-based (ex: the 80-125% effectiveness threshold is suggested to be removed).

We welcome the proposal to remove a number of restrictions to hedge accounting, in particular the possibility to designate derivatives, layers and risk components as hedged items. We also support the proposed solution to account for options' time value as insurance contracts. These developments contribute to make the hedge accounting model more in line with the way entities manage their risks.

However, though the exposure draft is seen as a step forward in terms of making hedge accounting more closely aligned to entities' risk management, we are concerned by the issues listed below:

- ineligibility of equity instruments measured at fair value through other comprehensive income as hedged items
- ineligibility of credit risk components as hedged items whereas these are widely hedged as part of risk management activities.
- specific requirements for inflation risk components;

Besides, as a financial institution, we are mainly concerned by the impacts of what is suggested for micro-hedging on macro hedging for which a number of issues need to be considered and solved in the macro hedging ED to be published, in particular:

- The bottom layer issue: in the exposure draft, a layer component that includes a prepayment option is not eligible to be designated as a hedged item. However, we support the IASB Board decision (in November 2010) to further consider for macro hedging, the concept of defining the hedged item as a bottom layer of an overall open portfolio of pre-payable instruments.
- The sub-LIBOR issue: the general model retained the IAS 39 restriction regarding the designation of the LIBOR component of a sub-LIBOR interest rate as the hedged risk

as the designated component should not exceed the total cash flows of the hedged item. We are concerned that sub-LIBOR deposits which constitute a stable resource for credit institutions, regarded as key elements for liquidity management purposes, remain ineligible to interest rate hedge accounting.

The issues relating to the hedging of equity instruments measured at fair value through profit and loss, bottom layers and sub-LIBOR components should also be solved for corporates. They could purchase sub-Libor bonds (for example a German Bond) and hedge them against interest rate risk by entering into an interest rate swap which fixes the interest rate. They also could be interested in hedging a bottom layer component of a closed portfolio for which it could be demonstrated through historical/statistical data that it is not affected by prepayments.

Most of the points above are inconsistent with the suggested hedging framework, notably with the possibility to hedge a component and the pro-active rebalancing process.

Our detailed answers to the questions are included below. Should you have any questions regarding our comments, please do not hesitate to contact Franck Lafforgue, Stéphane Denise or myself.

Sincerely,

Gerard Gil
Deputy CFO

Objective of hedge accounting

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?

- We agree with the proposed objective to reflect in the financial reporting, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks.
- To meet this objective, hedge accounting should be extended to financial instruments hedging all types of exposures that could affect the entity (ie: not limited to items that could affect profit and loss). Investments in equity instruments at fair value through other comprehensive income and share based payment transactions are examples of items that could be hedged as part of an entity's risk management strategy even though they do not affect profit and loss.
- To the extent that some actual risk management would *not* be recognized as hedging from an accounting perspective (credit risk hedging, sub-LIBOR items hedging....), financial reporting will *not* fully reflect the effect of an entity's actual risk management activities that use financial instruments. We therefore disagree with §4: "Hedge accounting shall not be applied to investments in equity instruments designated as at fair value through other comprehensive income".

Instruments that qualify for designation as hedging instruments

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 agree that non-derivative financial instruments should be permitted as eligible hedging instruments. This notably shows that derivatives should not be singled out but considered as other financial instruments.
- However, we see no conceptual basis for excluding financial instruments that are not at fair value through profit and loss as eligible hedging instruments.

Derivatives that qualify for designation as hedged items

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 agree with the principle of permitting the designation of an aggregated exposure that is a combination of another exposure and a derivative as a hedged item. We believe that this approach will enable hedge accounting to be more closely aligned with actual risk management practices.

Designation of risk components as hedged items

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?

- We welcome the decision to permit the designation of a risk component as a hedged item provided that the risk component is separately identifiable and reliably measurable.
- For the sake of clarity, and consistency with IAS39, we suggest that the text clearly states that partial hedging is possible (ie: full or partial term), as mentioned in IN37 since paragraph 18 (b) is not clear.
- However, we regret that specific rules are set in contradiction with the principle-based approach of the overall exposure draft and prohibit the hedging of:
 - a LIBOR component of a sub-LIBOR item
 - non contractual inflation components of financial instruments, and
 - credit risk components (cf response to Question 15).
- These restrictive rules will prevent banks from properly reporting their actual interest rate risk management activities in their financial statements.
- Sub-LIBOR issues arise from the B12 or B24 requirements that the hedged component is less than the hedged item (B12: "A component is a hedged item that is something less than the entire item"; B24: "... that component must be less than or equal to the total cash flows..."). This fails to convey actual risk management that focuses on each component separately: the interest rate risk component (typically LIBOR-based), credit risk component, commercial margin component. When hedging its interest rate risk component, the other components are *excluded* from the hedging relationship. Those other components may be positive or negative: this should not prevent from hedging the interest rate risk component.
- Preventing component hedging when the other components are or may be negative is a denial of the very notion of component hedging, and is consequently inconsistent with the suggested framework.
- For example, a German Bund is a below LIBOR asset (as of early 2011). When hedging its interest rate risk component, the negative component that should be added to the reference inter-bank interest rate (ie: LIBOR based) to obtain the German Bund yield has numerous non-interest rate-based rationales: German Treasury credit risk is deemed low and German Bunds are deemed very liquid bonds (ie: readily sellable), German Bunds are deliverable to European Future contracts; These three elements justify a global interest rate below LIBOR but are not linked to the interest rate component that the entity may want to hedge.
- As another example, a bank is usually able to get sub-LIBOR funding from its commercial activities. This is actually a positive margin for the bank (ie: a 'negative' margin added to LIBOR-based liability). As this margin is not part of the interest rate component hedging relationship, those items should be allowed to be hedged for their interest rate risk component.
- The issue of sub-LIBOR is a very important issue since it is at the very core of banking activity. This should be dealt with properly within the micro-hedging framework since it will constitute the crux of the macro-hedging framework to be published soon.

- Should those requirements remain as is, they would be completely at odds with the Basel III liquidity regulation on banks since banks have to increase their low (ie: below LIBOR) interest rate bearing liabilities (coming from retail and SME activities, deposits from cash management activities that are required to be below market rates, etc), and increase the amount of high quality liquid assets, most of which should be below LIBOR securities.
- In this context, rating agencies' methods to allocate ratings to banks are more and more focused on the amount of low interest bearing liabilities (ie: sub LIBOR liabilities), that this ED would prevent from hedging.
- In other words, with the ED as is, banks would be prevented from hedging their interest rate risks that derive from assets and liabilities that regulation requires them to have and increase: this is most probably an unintended consequence.
- We recommend that:
 - the requirements that prevent the hedging of sub LIBOR assets and liabilities are dropped, so as to recognize that the negative margins derive from components that are not part of the interest rate risk that is being hedged;
 - the hedging framework be :
 - principle-based (ie: not rule-base) and
 - consistent with its stated intent to be aligned with actual risk management similarly to what is mentioned in B38 for effectiveness "This means that information (or analysis) used for decision-making purposes can be used [...]"
- Inflation should be dealt with similarly to other risk components that can be hedged. There is no reason for B18 to require specific criteria to be met for the inflation risk component. As other types of risk components, the inflation risk that is hedged should be identifiable and measurable. The requirement for inflation to be contractually specified should be dropped off.

Designation of a layer component of the nominal amount

Question 5

- 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?
- 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 support the Board's decision to permit the designation of a layer of the nominal amount of an item or a group of items as a hedged item since this better reflects the way entities manage their risks.
- However, we do believe that for groups of items the designation of a bottom layer component of the nominal amount should also be permitted for contracts with embedded prepayment options as long as it can be demonstrated through historical/statistical data that for such closed portfolios, it is possible to identify a bottom layer component that is not expected to be affected by prepayments.

- We therefore support the Board's November 2010 decision to further consider the bottom layer of an overall portfolio of pre-payable instruments as a hedged item as this is a key issue for portfolio hedge accounting (both for micro/closed portfolio and macro/open portfolio).
- Actual interest rate risk management of pre-payable assets usually consists of dynamically hedging the interest rate risk exposure based on expected prepayments that change with market rates. The hedging instruments are regularly adjusted to adapt to changes in expected prepayments. This can be seen as a form of delta-hedging that is possible in the current IAS39-framework. Delta hedging activity is applied to either a portion of the portfolio or a bottom layer of the portfolio. In the latter case, the hedging instruments are before the fact adjusted only to the extent that expected balances are lower than the bottom layer that is being hedged.
- The hedging framework that is suggested by this ED is very consistent with actual interest rate risk management: whenever needed, hedging instruments are rebalanced so that the hedging activity remains consistent with the objective of the hedge. In that respect, there is no reason to prevent a bottom layer from being hedged when it may be affected by changes in expected prepayment if rebalancing is required.
- More precisely, a delta hedging strategy is consistent with
 - B59: "An entity may rebalance a hedging relationship if it aims to ensure that the hedging relationship will continue to meet the objective of the hedge effectiveness assessment." and
 - B47: "If a hedging relationship ceases to meet the objective of the hedge effectiveness assessment, or is expected to do so, an entity determines whether the risk management objective for that hedging relationship remains unaltered. If so, the hedging relationship is adjusted so that the new hedge ratio again meets, or is no longer expected to cease to meet, the objective of the hedge effectiveness assessment (rebalancing). Rebalancing is accounted for as a continuation of the hedging relationship in accordance with paragraphs B48-B60."
- ... subject to ineffectiveness be recognized at rebalancing date as stated in:
 - B47: "[...] On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised in profit or loss immediately before adjusting the hedging relationship"
- ... with ineffectiveness derived from the bank risk management.
- This is the reason why hedging a bottom layer of a pre-payable item should *not* be excluded but be subject to the other requirements in the ED. Excluding bottom layer hedging for pre-payable items would be inconsistent with both the rest of the text and with the intent of the text to be consistent with actual risk management activities.

Hedge effectiveness requirements to qualify for 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?

- We welcome the removal of the arbitrary 80%-125% threshold and the introduction of an objective based assessment of hedge effectiveness as this is more in line with risk management practices.
- We also welcome the removal of the retrospective hedge effectiveness testing and the designation of hedge effectiveness criteria that are closely aligned with entities' risk management strategies.

- We welcome the B34 statement, "... when the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to conclude on the basis of a qualitative assessment of those critical terms that the hedge ineffectiveness, if any, would not be expected to produce a biased result".
- We welcome the B38 statement, "An entity's risk management is the main source of information to perform the assessment whether a hedging relationship meets the hedge effectiveness requirements." since it helps ensure the alignment between actual risk management and accounting representation of the operations entered into as a consequence of risk management strategies.
- The hedge effectiveness should be consistent with the rebalancing framework that is suggested in the ED, notably the rebalancing flow chart specified in B46. The pro-active rebalancing helps prevent ineffectiveness before it might occur, enabling the maintenance of effectiveness. In other words, the hedge effectiveness test might take into account pro-active rebalancing.
- Requiring that (B38) "[...] the hedging relationship will produce an unbiased result and minimise expected hedged effectiveness" makes sense. However, it should be accompanied with references to a materiality principle so that the "bias" is understood as "no material bias". This would ensure consistency with actual risk management and would avoid requiring a non significant rebalancing process that would be cost inefficient for no material value added.

Qualification and effectiveness of internal hedging transactions with external offsetting

- To comply with the current IAS39 hedging framework, banks have developed processes to prove that internal transactions between a hedging department, notably Asset and Liability Management department, and the Fixed Income department are offset by external transactions between Fixed Income and external counterparties. These processes allocate portions of external derivatives to internal derivatives so that the external derivatives duplicate internal derivatives so closely that accounting for external derivatives as hedging instruments is similar to accounting for internal derivatives as hedging instruments.
- The allocation process is performed frequently (at least monthly, if not daily), so that the duplication process is very accurate. By doing so, the external transactions that are used to duplicate internal transactions may not be the same from one period to the next.
- As seen from this hedging ED, the rebalancing process that is suggested should be seen as a proactive rebalancing process that makes sure that there is minimal expected ineffectiveness.
- This is also consistent with paragraph 24: "the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy".
- The costs incurred by the implementation of this process were significant and we appreciate that the ED offers the opportunity to continue to use it.

Rebalancing of a hedging relationship

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?

As this is aligned with, and in fact derived from actual risk management, the suggested rebalancing framework combined with actual risk management-based ineffectiveness make sense:

- proactive rebalancing to make sure that the hedging relationship keeps close to the hedge effectiveness objective. with a hedging continuation process, including to demonstrate that external transactions offset internal transactions (cf answer to Question 5);
- compulsory rebalancing when the risk management objective has not changed and the hedging criteria are no longer met; with accounting for ineffectiveness test at rebalancing date.

Discontinuing hedge accounting

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?

- We agree that hedge accounting should be discontinued prospectively *only* when the hedge relationship ceases to meet the qualifying criteria, which includes alignment with risk management objective.
- Should the risk management objective change for a specific hedging relationship, the bank should discontinue the hedging relationship to make sure hedge accounting is aligned with risk management activity. The effective portion of the hedging instrument as of the hedging objective change date should be accounted for as described in paragraphs 28 (fair value hedge) and 30 (cash flow hedge).

Accounting for fair value hedges

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?

- We agree with the IASB decision not to replace the fair value hedge accounting mechanics with the cash flow hedge mechanics as it would have generated undue volatility in Other Comprehensive Income.
- However, we believe that the two step approach, where ineffectiveness is first accounted for in Other Comprehensive Income and then transferred to profit and loss increases the complexity of hedge accounting for no real improvement in the quality of information provided.
- We agree with the proposal to account for the valuation adjustment of the risk being hedged in a separate line in the statement of financial position adjacent to the line that includes the hedged asset or liability as there is no rational in adjusting amortised cost with a fair value adjustment.
- However, for entities that broadly use hedge accounting, this presentation would significantly increase the number of lines in the statement of financial position which may heavily alter the clarity and understanding of the financial statements. We therefore suggest to report a single amount that would be the aggregation of all fair value hedge adjustments as is done under IAS39 for portfolio fair value hedges in the statement of financial position.
- We agree that a linked presentation is not an appropriate solution for fair value hedges as the purpose of the balance sheet is to reflect all assets and liabilities rather than to demonstrate risk management activities of the entity.

Accounting for the time value of options for cash flow and fair value hedges

Question 10

- a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?
- b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?
- c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

- We welcome the solution to account for the time value of options for cash flow hedges and fair value hedges in other comprehensive income as we do believe that the time value of options (known at inception) represents the cost of hedging and should not create undue volatility in P&L.
- However, we acknowledge that, although consistent, the distinction made between transaction related and period related hedged items introduces some operational complexity.

Eligibility of a group of items as the hedged item

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?

- We agree with the eligibility criteria of groups of items as long as these concern closed groups of items.
- However, as we understand that these criteria are a step towards the development of an accounting model for portfolio hedge accounting we believe that further consideration should be given to risk management practices as regards to the hedging of open portfolios in order not to introduce in the standard rules such as sub LIBOR components and layer components with prepayment options that would be inconsistent with the way financial institutions hedge their risks.

Presentation (groups of hedged items)

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?

We agree with the principle to present on one separate line of the income statement the hedging gain or loss of a group of hedged items with offsetting risk positions that affect different line items in the income statement.

Disclosures

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?

- Whilst we understand that disclosures should be improved to provide users with useful information about the entity's risk management strategies and the effect of hedge accounting on financial statements, we are concerned that the information required to be disclosed is extensive and would suggest that a possibility be given to refer to other disclosures of the annual report when these cover the requirements of the present exposure draft as long as these are audited. This would be the case for an important part of interest rate risk disclosures for financial institutions that have to comply with Basel pillar III.
- We consider that the disclosures proposed should enable users to gain a good understanding of an entity's risk management strategy and the impact of hedge accounting on its financial statements.

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative

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?

As a financial institution we are not directly concerned with the "own use" exception.

Accounting for credit risk using credit derivatives

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 do believe that none of the three Fair Value Option alternatives is satisfactory. Indeed, having to fair value all the risk components of a hedged instrument would not reflect our risk management strategy and would generate a mismatch between the hedging instrument and the non-credit risk components of the hedged instrument.
- In the context of stronger transparency and comprehensive risk requirements, a global credit risk management is a must. Unfortunately the current accounting framework only allows sporadic actions and the existing restrictions generate volatility in profit and loss which in some circumstances can be counterproductive for risk management strategies. If the purpose of the new exposure draft is to make the hedge accounting more closely aligned with risk management, we suggest that a solution should be found to enable risk management activities to be better reflected in financial statements.
- In market practice, the credit risk is managed through Credit Default Swaps widely used to hedge, especially by the Credit Portfolio Managers community. Based on this fact, we believe that CDS should be eligible hedging instruments from an accounting point of view. Thus, CDS is considered as the best approximation to assess credit risk components of a debt instrument (see appendix 1) and the gap that could arise between a CDS and the credit risk component of a debt instrument can be measured and has no significant impact as demonstrated in appendix 1 paragraph 2. The credit risk component of a financial asset could be measured using the related CDS curve adjusted to take into account the asset's particularities (for example prepayment option, Recovery Rate different to that of the CDS...). This methodology can reliably measure the credit risk component and any inefficiency that could arise in the hedging relationship.

Effective date and transition

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 prospective application proposed by the exposure draft, which is more operational than a full retrospective one.
- Besides, we support the treatment of hedging relationships that qualify both under IAS 39 and under proposed standard as continuing hedging relationships, however, it is not clear how previous fair value hedges which remain eligible to hedge accounting should be accounted for/restated and how hedges which become ineligible should be discontinued.

Appendix 1:

Analysis of the impact of the differences mentioned by BC221 between a credit default swap and a debt instrument on the value of the credit risk inherent in the reference obligation:

○ Funding :

As noted by the IASB, there is a difference in funding between credit default swaps and debt instruments. However, the funding component of the debt instrument is not part of the credit risk component, and therefore should not be part of the hedged risk component. In practice, market participants use unfunded interest swap rates to strip the credit risk component of the credit swap instruments, while funded rates, such as LIBOR rates, must be used to value loans. The difference between LIBOR rates and overnight index swap is widely used as a market proxy for the funding component.

○ Coupon accrual on default

The IASB rightly noted that there is a difference between the coupon accrual of a credit default swap and the absence of a coupon accrual in most defaulted debt instruments. However, this difference, which is limited to at most the coupon accrual in 3 months, can be accurately quantified to fairly measure the credit default risk of the debt instrument while using credit default swaps. In practice, this difference is insignificant.

○ Counterparty credit risk

Counterparty credit risk is very limited due to margin calls and collaterals being paid or received, in particular through CSA agreements. It is to be noted that internal rules could require to, deal only with a very limited list of market participants, of high credit quality and tied with CSA agreements. In addition, credit default swaps are soon to be traded within clearing houses further reducing the counterparty credit risk through initial margin posting, trade portability, and guaranty funds. In addition, despite the above described issues, in exceptional cases where the residual counterparty credit risk becomes no more negligible, it can itself be isolated, measured and taken into account to properly measure the credit risk of the hedged debt instrument.

○ Defined credit events

It is understood that the IASB described the credit risk as such in IFRS 7: *“The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation”*. CDSs have been conceived to be triggered in case of credit risk. Considering standard Credit default swap instruments, credit events are defined in the 2003 ISDA Credit Derivatives Definitions which may include: bankruptcy; failure to pay; repudiation/moratorium; obligation acceleration (triggered by a default or other event); and restructuring.

Regarding restructuring it states in section 4.7 that restructuring is defined by a reduction in rates, a reduction of principals, a postponement of either the rate or principal, a change in the ranking causing a further subordination, or a change in the currency to a non-permitted currency. It also states that these events should result directly or indirectly from a deterioration in the credit worthiness or financial condition of the reference entity to define a restructuring event. These provisions ensure that a restructuring is associated with a financial loss by the failure to discharge the initial obligation triggered by the creditworthiness of the entity. In practice, the definition and interpretation of the “restructuring” is thus done to reflect this credit risk as accurately as possible.

European contracts have MMR (Modified Modified Restructuring) as the restructuring standard. This means not only that the buyer is protected from restructuring credit events but also that there are restrictions on the maturity of the debt instruments deliverable into the contract - thereby significantly reducing the impact of the “cheapest to deliver” options.

Standard North American CDS contracts trade with NR (No Restructuring) - meaning that restructuring is not a credit event for standard North American CDS contracts. This reflects the fact that restructurings are not as widely used in North America due to the wide use of the chapter 11 of the U.S. Bankruptcy Code. However, market participants who require restructuring as a credit event are still able to do so, even if this is not the standard.

- “Cheapest to deliver” option

In cases where all debt instruments become due, such as “bankruptcy” or “failure to pay” credit events, there is no “cheapest to deliver” option. Even in case of restructuring, ISDA standard contracts include provisions capping the maturity of deliverable debt instruments since 2003 as discussed above. This is limiting the effect of the “cheapest to deliver” feature. In addition, since 2009, ISDA standard contracts made the “auction process” mandatory; most hedged instruments, in case of limited maturity mismatch and in the absence of provisions forbidding their transfers, can be settled at the final price determined by an auction process.

- Differences in liquidity between the credit default swap and debt markets:

Differences in liquidity between the credit default swap and debt markets do exist. Debt markets, especially regarding loans are less liquid but we believe that the liquidity component of the debt instrument is not part of the credit risk component, and therefore is not part of the hedged risk component. On the contrary, credit default swap instruments are usually much more liquid than hedged instruments and therefore the best instruments to measure accurately the credit risk component. In addition, the liquidity of the credit default swap instruments can be measured e.g. through the difference between bid and ask spreads and thus taken into account.

- The effect of auction processes when credit default swaps are settled as a result of a credit event:

The ISDA “Big Bang” protocol actually ensures that all contracts settled via the auction (CDS documentation). At the end of the auction process, market participants can opt for the cash settlement; in addition, the buyer of the protection can also opt for a physical settlement by placing an order with one of the dealers represented in the auction process. Whatever the effect of the auction processes, it should be first stressed that market participants can still trade non-standard credit default swap instruments by mutual consent of both counterparties to be able to settle their contracts outside of the auction. Besides, most importantly, auction processes are market-based and thereby have objective processes to value the debt instrument at delivery. They have been specifically discussed and implemented by financial institutions to determine the recovery rate as accurately as possible.