

Madrid, 9 March 2011

Sir David Tweedie  
Chairman  
International Accounting Standards Board (IASB)  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

[commentsletters@iasb.org](mailto:commentsletters@iasb.org)

**Re: IASB Exposure Draft on Hedge Accounting**

Dear Sir David,

Banco Bilbao Vizcaya Argentaria, S.A. appreciates the opportunity to provide you with our comments on the Hedge Accounting Exposure Draft ED/2010/13 issued in December 2010. We firmly support the European Banking Federation (EBF) position about this exposure draft, therefore, in this letter, we are going to emphasise only the issues we consider more relevant for our Group.

BBVA welcome the high-level aim of the ED to simplify hedge accounting and the proposed objective of representing the effect of an entity's risk management activities in the financial statements. Overall, we consider it is move on the right direction. However, there are some concerns we would like to share with you as, from our perspective, some proposals would not allow achieving these objectives:

- Hedge of equity instruments under the OCI option
- Hedge of forecast of future results in net foreign investments
- Hedge of the market risk originated by the assets or liabilities in a business combination

On the other hand, the ED considers hedge accounting only in the context of groups of items that constitute a gross position or a net position in closed portfolios when banks, in general, operate open portfolio macro hedging in order to manage their risks. Therefore we encourage the IASB to accelerate the discussion initiated in November 2010. In this regard we expect the Board will give a proper answer to the following concerns for the financial industry, which are explained later in this letter:

- Potential implications of the alignment of risk management with accounting
- The Sub-libor issue
- Layer approach for financial instruments with prepayment options

**As we said before, the issues we consider more relevant for our Group are the following,**

## **1. Hedge of equity instruments under the OCI option**

According to the ED, the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss. As gains and losses on equities under the OCI option would never be recycled to the income statement, these instruments are not valid hedged items.

However, some available for sale equity instruments are currently managed and hedged with the objective of achieving a certain level of gains in OCI, regardless whether those instruments are subsequently sold and the gains in OCI are recycled to P/L. OCI is part of the Equity of the entities and therefore, it has a direct impact in their solvency ratios. In other words, entities use valid hedging strategies for capital risk management purposes.

Furthermore, these available for sale equity instruments are valid hedged items under current IAS 39, resulting in an alignment between management practices and accounting (fair value hedge). If entities were not allowed to hedge these financial instruments, there would be volatility in P&L that would not reflect the true and fair view of the risk management activities, losing the coherence that currently exists.

Therefore, we propose a model where instruments under the OCI option are eligible for hedge accounting and where the ineffectiveness of the hedge is recorded as part of the cost of the instrument being hedged. Therefore, the ineffectiveness of the instrument under the OCI option would never be recycled to profit and loss.

## **2. Hedge of forecast future results in net investments in foreign operations**

Current IAS 39 does not allow to do hedge accounting of forecast future results in a net in foreign operations as they are not included as hedged items. The ED does not change this approach and we consider that this issue should be reopened for discussion in the ED on hedge accounting.

There are two risks related to forecast results in foreign currency: translation risk and transaction risk. Both of them can be hedged:

1. Translation risk has traditionally been said to have only an accounting effect but it also has a very important economic effect: exchange rates movements affect reserves and risk weighted assets, and therefore they will have a direct impact in all the components of the capital ratio. That is the reason why the exchange rates of future results are also being managed at Group level with a 2 or 3 years horizon.
2. Alternatively, transaction risk could be chosen to be hedged. This is the risk resulting from the exchange rate of future dividends from the subsidiary to the parent company. In this case companies want to assure favourable exchange rates for the cash that will be received from subsidiaries in the coming years. We



consider that there is no conceptual reason why to wait to hedge those dividends until they are announced, as long as a good estimate can be done:

- 2 or 3 years of forecasted banking results are predictable with a “highly probable” criterion, especially in retail businesses that are more stable.
- Pay outs can also be predicted based on the entity strategy and group policy of dividends.

As a way to get closer to the “highly probable” criterion, companies could be able to hedge a percentage of forecast results based on the expertise of management and thus achieve a highly effective hedge.

### **3. Hedge of the market risk originated by the assets or liabilities of an acquired company**

We advocate allowing hedge accounting for other identified and measurable risks in a firm commitment / highly probable forecast transaction, in order to improve the capability of the acquirer in a business combination to hedge these other risks, and doing it when the transaction is on the due diligence period. Therefore, we propose to allow hedge accounting not only for foreign currency risk, but also for the market risk originated by the assets or liabilities of the acquired company if these can be identified and reliably measured.

**As we previously commented, from our perspective it is of much importance to get a satisfactory answer for the following items in the macro-hedging discussion:**

#### **1. Implications of the alignment of Risk management with accounting**

We welcome the new proposed approach of the ED for Hedge Accounting, which is to reflect the entity's risk management activities on accounting. However, we wonder how this could impact the way some financial entities account for their management of core deposit risks.

Financial entities manage the interest rate risk related with these deposits and, as current IAS 39 does not allow their accounting hedging it is an extended practice to assign the derivatives used in these economic hedges to the assets of the company, and establish an accounting hedge. Although this practice is very onerous (assets imply capital charges and sometimes some ineffectiveness is achieved), an approximate accounting outcome is reached. However, with the new approach in the ED, this accounting hedge probably could not qualify because the designated hedged items (assets) would not be aligned with the managed risks (core deposits). Therefore, we encourage the Board to take into account this fact in the definitive St

#### **2. Layer approach for financial instruments with prepayment options**

We fail to see why a layer component of contracts 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. We could understand that approach when



hedging an individual instrument but the prohibition loses its sense when hedging groups of instruments. In those cases, the entity is already taking into account the forecasted prepayment scheme in the company. Therefore, regarding a group of instruments, prepayments do not affect the hedging strategy and therefore, a bottom layer should be permitted to be designated in a fair value hedge regardless it has prepayment options or not.

### **3. The “Sub-libor” issue**

The IASB retains the requirement in IAS 39 that entities cannot designate a portion of an instrument that is bigger than the total of the cash flows of the hedged item. This implies that for a financial asset or liability with a negative spread over a benchmark (Libor/Euribor) an entity could only designate as hedged item all of the cash flows of the entire instrument, not just the Libor/Euribor component.

As it can be read in Staff Paper 16 (18 October 2010), the IASB is aware of the concerns of the financial entities: not allowing entities to designate just the Libor component prevents entities from reflecting their risk management activity. However, the IASB keeps thinking that the designation of a LIBOR component in sub-LIBOR instruments is inappropriate from an accounting perspective as in scenarios in which LIBOR drops below the spread the outcomes would be inconsistent with the economics of the instrument being hedged (eg negative interest in assets; cost of funding – financial liability + derivative - inconsistent with the issuer’s credit worthiness, that is, when the LIBOR decreases the entity pays higher interest).

The IASB staff believes that these possible outcomes should not be ignored as there is always the possibility that LIBOR might go below the margin or implied margin (in cases when the hedged item is a component of a fixed rate sub-LIBOR instrument). Therefore, the staff thinks that in case it were possible to designate a LIBOR component in a sub-LIBOR instrument such designation would need to be supplemented by guidance on how to determine the probability of reaching the limit for automatic discontinuation (because LIBOR reached the absolute value of the spread). Additionally, the staff also thinks that this will introduce complexity. Therefore, following the staff recommendation, the Board has decided to maintain the prohibition of designating the LIBOR component in a sub-LIBOR instrument.

We do not support this approach as Sub-Libor/Euribor instruments, either as a variable rate or as a fixed rate, are a common source of financing in banks. In our view, an additional guidance for determining whether the probability of reaching the limit for automatic discontinuation is not necessary because in case the Libor/Euribor falls below the level of the spread in a hedged instrument:

- The hedge relationship would become ineffective.
- The risk management objective and the strategy would not normally allow to continue that hedge.

Therefore, the hedging relationship would cease to meet the qualifying criteria and the entity should discontinue hedge accounting. In conclusion, the proposed



discontinuation rules would allow entities to present their hedging activity of their financial margin "through the eyes of management".

**Finally, as we mentioned, some of our clients have a specific concern we want to share with you although it is not a relevant issue for us,**

Some of our clients (non-financial institutions which have debt that is financing a concession contract according to IFRIC 12) understand that in certain type of derivatives, where the hedging relationship is straightforward (as they are entered into separately but are linked to a financing contract with the sole purpose of adjusting the conditions of the financing), more decision-useful information would be provided for users if they were carried together with the hedged debt instrument, instead of applying fair value to the derivative. This is the case for example, where a variable-to-fixed interest rate swap combined with a variable-rate borrowing results in the same cash flows as a plain-vanilla fixed-rate loan, or of an index linked swap combined with a fixed rate bond that results in an inflation linked bond.

The obligation to measure these derivatives at fair value introduces high volatility into equity of the companies concerned, and it does not contribute to represent a true and fair view of the companies as the instruments are not held for trading but are held to maturity linked to the loan in order to adjust the interest cash-flows of the loan.

According with the arguments exposed, the proposal is that certain types of swaps will not be measured at fair value; but at amortized cost together with the hedged debt instrument when complying with the following conditions:

- The company enters into the swap in order to adjust the financing terms of a loan, being the final result, from the point of view of the cash flows, the same as a loan measured at amortized cost.
- The company has a clear intention and a real possibility to maintain the swap until maturity.
- The swap does not have a speculative purpose.

Extensive disclosures regarding the fair value of these derivatives should be provided in the financial statements.

We would be pleased to discuss our comments or answer any questions that you or your staff could have. Please contact Jaime Vázquez Castro (+34 91 5378197) or myself.

Yours faithfully,

A handwritten signature in blue ink, appearing to be 'Jaime Vázquez Castro', written over a horizontal line.

## Questions:

### 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?

BBVA firmly supports the high-level aim of the ED to simplify hedge accounting, and the objective to represent in the financial statements the effect of the entity's risk management activities. Nevertheless, the objective of entities with hedge accounting is not only to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss, but also to protect their Equity. The proposed objective in the ED is not perfectly aligned with the aim of reflecting in the statements how entities manage risks, as entities manage risks that have an impact not only in P&L but also in OCI. Furthermore, it should be taken into account that financial entities also manage capital requirements and OCI is directly related with capital requirements.

In this regard, some available for sale equity instruments are currently managed and hedged with the objective of achieving a certain level of gains in OCI, regardless whether those instruments are subsequently sold and the gains in OCI are recycled to P/L. OCI is part of the Equity of the entities and therefore, it has a direct impact in their solvency ratios. In other words, entities use valid hedging strategies with the aim of protection of capital. These available for sale equity instruments are valid hedged items under current IAS 39 hedge accounting requirements resulting in an alignment between management practices and accounting (fair value hedge).

However, equity investments for which the OCI accounting alternative is elected under IFRS 9 cannot be hedged instruments in the ED and therefore, hedge accounting is prohibited for them. The rationale for this is that, according to the ED, the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks *that could affect profit or loss*. As gains and losses on equities under the OCI option would never be recycled to the income statement, these instruments are not valid hedged items.

The Board decided not to extend that definition because they believe complexity would be added in terms of accounting ineffectiveness as one of these accounting principles would be necessary contradicted (BC22-BC27):

- The principle in IFRS 9 of not reclassification between OCI and P/L in Equity instruments under OCI option, or
- The principle of recognising hedge ineffectiveness only in P/L.

This means that hedges that are currently allowed would no longer be permitted under the new hedge accounting model. Taking into account that two of the objectives of the ED are

- to improve the decision-usefulness of financial statements for users by fundamentally reconsidering the current hedge accounting requirements and to achieve a better alignment between risk management and accounting, and



- to deal with the contradiction of the accounting principles detailed before,

We propose a model where the ineffectiveness of the hedge should be recorded as part of the cost of the instrument being hedged. Therefore, this ineffectiveness of the instrument under the OCI option would never be recycled to profit or loss. This is the alternative we firmly think fits best with the model proposed in the ED. If this is not possible, there are another two other alternatives we could propose to permit hedge accounting of instruments under the OCI option:

1. To extend the definition of fair value hedges: including in the objective of the ED that entities “... to manage exposures arising from particular risk that could affect profit or loss or OCI”. We do not foresee any problems in allowing the hedging of strategic investments, specially in the actual accounting framework in which more and more items are in OCI and the IASB recognises its importance in the project “Presentation of items of OCI” when proposing that all income and expenses that are components of the total non-owner changes in equity should be presented together, or
2. To allow, as an exception to the general criteria, the reclassification between OCI and P/L when hedging these instruments to show the ineffectiveness.

We firmly advocate including the model where the ineffectiveness of the hedge could be record as part of the cost of the instrument being hedged, or one of the two alternatives detailed before as, from our perspective, neither of these proposals would add complexity to hedge accounting. Furthermore, we consider that prohibiting hedge accounting for equity investments at fair value through OCI simply because it does not fit within the existing accounting model it is not a valid argument. The accounting model is currently being changed to better align accounting with risk management and this prohibition would be a true misalignment and a step back in hedge accounting rules.

### **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?

Yes, we agree.

### **Derivatives that qualify for designation as hedged item**

#### **Question 3**

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

Yes, we agree.

## 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 proposal to allow hedge accounting for components of risk, but there are still some aspects that should be reconsidered as the sub-libor issue. The IASB retains in the ED the requirement in IAS 39 that entities cannot designate a portion of an instrument that is bigger than the total of the cash flows of the hedged item. This implies that for a financial asset or liability with a negative spread over a benchmark (Libor/Euribor) an entity could only designate as hedged item all of the cash flows of the entire instrument, not just the Libor/Euribor component.

IASB is aware of the concerns of the financial entities: not allowing entities to designate just the Libor component prevents entities from reflecting their risk management activity. It is true that in scenarios in which LIBOR drops below the spread, the outcomes of a hedge would be inconsistent with the economics of the instrument being hedged (eg negative interest in assets; cost of funding – financial liability + derivative - inconsistent with the issuer's credit worthiness, that is, when the LIBOR decreases the entity pays higher interest). However, from our perspective in these cases the general rules of hedge accounting can be applied with a satisfactory outcome. Thus in our view:

- It should be possible to do hedge accounting of the Libor/Euribor risk as a benchmark component and treat the spread as a negative residual component because that is the way financial entities typically manage interest rate risk. Sub-Libor/Euribor instruments, either as a variable rate or as a fixed rate, are a common source of financing in banks.
- An additional guidance for determining whether the probability of reaching the limit for automatic discontinuation is not necessary as the proposed rules for rebalancing and discontinuation accounting hedges can be used with a satisfactory result. This means that in case the Libor/Euribor falls below the spread in a hedged instrument two facts take place:
  - The hedge relationship becomes ineffective.
  - The risk management objective and strategy probably have changed as that risk no longer wants to be hedged.

Therefore, the hedging relationship would cease to meet the qualifying criteria and the entity should discontinue hedge accounting (we do not find a reason why the risk management objective could not have changed and therefore the entity should be forced to rebalance the hedging relationship). In conclusion, the proposed discontinuation rules would allow entities to present their hedging activity of their financial margin "through the eyes of management".



## Designation of a layer component of the nominal amount

### Question 5

(a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?

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

We welcome the proposal to allow designating a bottom layer of the nominal amount of an item as the hedged item. Nevertheless, we fail to see why 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.

When an entity uses a layer component on its hedging strategies for a group of instruments, it is already taking into account the forecasted prepayment scheme in the company. Therefore, in a group of instruments, prepayments do not affect the hedging strategy.

## 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 simplification of the methodology for achieving hedge accounting.

## 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?

In relation with rebalancing and interrupting a hedge accounting, we think that a more clear definition of what the Board effectively means with “strategy and management objective” should be developed in order to achieve coherence between entities. In this regard, some guidelines or examples would be welcome.

## **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?

In our opinion, this policy seems to be too restrictive. From our point of view, as hedging is dynamic, the interruption of hedges should be more flexible, and should be based on a deeper and better supervision of strategies. Additionally, a mechanism for spreading of the results of interrupted hedges should be articulated in order to avoid arbitrage.

## **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 proposed accounting.

## **Hedges of a group of items**

### **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 proposed criteria.

**Presentation**

**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 proposed presentation.

**Accounting alternatives to hedge accounting**

**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?

**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 agree that accounting for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments and that the three alternatives proposed in the ED are complex and do not reflect properly the way credit risk is managed, therefore we propose a simplified treatment; taking into account that buying a CDS is equivalent to buy an insurance on the credit risk of an instrument, we advocate a simplified model where the CDS premium is spread over the life of the hedge (protection period) and the value changes of the derivative are recorded in OCI.

**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?

As we stated on our response to the Board Request for Views on Effective Dates and Transition Methods for the new International Financial Reporting Standards (IFRSs) of 27 January 2011, BBVA considers that at least three years implementation time will be necessary for all the new standards planned to be issued by the Board, taking into account that these standards are interrelated. This would lead to an effective date of 1 January 2015.

Regarding the transition method, we advocate for a retrospective approach where the new requirements should be applied for the existing operations as of the beginning of the year in which the standard is adopted, without restatement of comparative amounts. This would increase comparability and would avoid the need for maintaining double method of accounting for the same strategies. Additionally, entities should make disclosure of the main changes with their impact in the financial statements.