

Luxembourg, 23 February 2010

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

**Subject: Comment letter on the exposure draft *Hedge Accounting***

Dear Sir/Madam,

We thank you for providing us the opportunity to respond on your exposure draft *Hedge Accounting*.

Overall, we recognise that the IASB proposals represent a major improvement as compared with IAS39, in particular for Corporates. The main benefits for preparers in the financial services sector will probably stem from the upcoming Exposure Draft on hedge accounting prescriptions for open and dynamic portfolios.

However, our annexed comment letter highlights our concerns with respect to some of the proposals. In particular, we believe that there is a need for robust disclosures to compensate for the additional level of judgment required (which is the logical consequence of replacing a rules based standard with a more principle based standard). For example, the ED does not require disclosure on rebalancing that occurred during the reporting period (e.g. frequency and reasons to do so) which we believe to be important information for the user in order to assess the real risk management strategy of the entity during the reporting period.

We also wish to draw your attention to the fact that preparers have, under IAS 39, often used the Fair Value Option as a surrogate for Hedge Accounting, for practicability reasons. The final transition prescriptions for entities that migrate from IAS 39 to IFRS 9 should clearly articulate the possibilities of replacing the “old” Fair Value Option by the “new” Hedge Accounting, for existing assets and liabilities.

You will find enclosed our detailed observations and responses to the questions raised in the Exposure Draft.

We remain of course available should you wish further clarification on our opinion.

Best regards,

Henricus Seerden  
European Investment Bank

**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?

Overall, we welcome the proposed objective which establishes a clear link between hedge accounting and the entity's risk management strategy and activities. We believe that the reliance on internal risk management methodologies used by the entity to assess their economic hedges will improve the link between economic hedges and hedge accounting. We also have the following comments:

- in order to achieve the stated objective, we believe that disclosures should also include information in a single comprehensive note on the residual un-hedged exposures to risks so that the user has one global overview of the risk management strategy of the entity.
- the distinction between a risk management strategy and a business strategy must be clearly articulated. This is particularly true in the case of linear hedges, whereby a protection of the downside also implies giving up the upside. As a consequence, in those cases, there will often be no bright line between taking a position in a risk component or hedging it away.
- hedge accounting is needed when there is mixed measurement. Indeed, mixed measurement without any remedy gives results that do not faithfully represent the underlying economic reality. On this basis, we conclude that if there is an economic hedge and a mixed measurement between the hedged item and the hedging instrument, then hedge accounting should be mandatory to achieve the most faithful representation of the economic reality.

**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?

Overall, we support this proposal. However, we believe that to properly portray the risk management activities of the entity, as stated in the proposed objective, the range of eligible hedging instruments for hedge accounting should be extended to those instruments which are used in practice as such, even if they are not measured at fair value through profit or loss (for example those instruments measured at fair value through OCI).

**Question 3**

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

We agree with the proposal as it is a reflection of how risk management is articulated in practice in many entities.

**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 support the IASB approach not to have distinct requirements for financial and non-financial instruments. We believe that the proposed principle to allow designation of risk components on the basis that there are separately identifiable and reliably measurable is more closely aligned to risk management practices.
- We believe that paragraph B18 that singles out inflation as a very particular risk may create confusion and given the above is not needed. Indeed, as long as inflation is considered to be neither separately identifiable nor reliably measurable, then it is not eligible as a risk component for hedge accounting purposes (the fact that it is contractually specified implies that it is separately identifiable and reliably measurable). In our opinion, adding this example creates confusion as there would be several other components that could be in the same situation as inflation. Furthermore inflation is often a perfectly measurable component of both financial and non-financial contracts.

**Question 5**

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

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

- (a) We agree with the proposal as it makes a clearer link with risk management strategies applied in practice. Furthermore, allowing designation of layers will minimise ineffectiveness.
- (b) We disagree with the proposal to exclude layer components of contracts that include a prepayment option from the scope of eligible hedged items. We believe that this proposal could be a significant issue for financial institutions given the important volumes of loan portfolios including such prepayment options. Consequently, we urge the IASB to perform field-testing to assess the potential effect of this proposal on major entities.

**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 agree that in order to be consistent with the objective of a hedge accounting that reflects the risk management strategy of the entity, the measurement of hedge ineffectiveness should also be aligned with the quantitative method used to assess hedge effectiveness prospectively (also to be consistent with the determination of the “optimal hedge ratio” i.e. the one that minimises ineffectiveness).
- Furthermore, quantitative methods that prospectively assess effectiveness (or lack thereof) are often not fit to assess retrospectively the realised ineffectiveness. Therefore, and also to increase comparability, we also agree with the IASB proposal to use one single method to measure ineffectiveness retrospectively, namely the dollar offset method.

**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?

Although the notion of rebalancing will principally affect hedges made by corporates, we would like to make the following comments:

- Overall, we agree with the principle of introducing the notion of “rebalancing” to allow entities to report changes occurred in its risk management strategy without suffering the drawbacks resulting from the current hedge accounting requirements (i.e. mandatory discontinuation and related consequences in profit or loss).
- However, we believe that clear guidance should be developed on rebalancing. B50 indicates that this is a matter of judgment but we can expect practical issues in particular, at which point in time fluctuations around the hedge ratio will cease to be considered temporary deviations from a trend that is still intact and will become a change in the trend itself. Furthermore, the Exposure Draft should make clearer the fact that even if rebalancing is mandatory in accounting terms, the entity is never required to adapt its economic hedges, i.e. enter into external transactions, merely because of the rebalancing prescriptions.
- Finally, we believe that it will be difficult for the user to understand the consequences in the primary financial statements of rebalancing given the level of judgment involved. This should be compensated by robust disclosures on the consequences of rebalancing and the reasons to do so (which do not seem to be explicitly foreseen in the section on disclosures in the Exposure Draft).

**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?

- Overall, we agree with the proposals on rebalancing, except for the points raised above in our answer to question 7.
- We 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 because otherwise this would enable entities to migrate derivatives back and forth between hedging and trading in opportunistic ways.
- However, we believe that a strict rule on discontinuation is not practicable for those entities where the external derivative is the net result of a cascade of internal derivatives. The upcoming Exposure Draft on portfolio hedging should also tackle such issues.

**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 accounting mechanics presented in the Exposure Draft. In particular, we support the introduction of a separate line item for hedge accounting adjustment to maintain clear and defined measurement attributes for financial assets and liabilities.
- We agree that linked presentation should be avoided as it may create confusion.
- However, we believe that the presentation approach proposed in the Exposure Draft i.e. presenting the separate line item next to the line item that includes the hedged asset or liability may reduce the clarity of the primary financial statements by multiplying the number of line items.
- As an alternative, we would propose to have a single item in the statement of financial position which represents the aggregate net amount of all the changes in

fair value from all the fair value hedges of items within the assets and liabilities. The link between the gross amounts of total hedge adjustments and the relevant asset or liability, which we agree is important information to be provided to the user of the financial statements, could easily be presented as a disclosure.

- Finally, we believe that the two-step approach whereby the ineffectiveness is presented in OCI on a separate line item will lead to an additional burden for preparers and will not provide additional information to the users. Indeed, the user wants to assess to which extent the risk management strategy of the entity has been effective and this can easily be derived from the level of ineffectiveness recognised in the income statement combined with disclosures.

#### **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 do not understand why options have been singled out with respect to the time value issue. We believe that other instruments should also have been included in the scope of review to ensure an homogeneous treatment of the time value concept
- We believe that the proposal is too rule based, with the risk that entities will let their choice of hedging instruments be influenced by an accounting rule. Contrary to the expected effect, it might even have the effect of taking less recourse to options as a hedging instrument.
- Furthermore the proposals lead to an artificial split of components of an option price, which is inconsistent with economic models such as the Black/Scholes model, in particular when using "time period related" hedged items. In the latter case it is hard to give a "meaning" to the amount in OCI which is a delta between a linear amortisation of initial time value and the fair value variation of that same time value.
- A principle based pronouncement on how to account for the remaining time value in any derivative instrument would be welcome.

**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?

- Overall, the new requirements seem to be as complex as the previous ones. Potential issues arising as a consequence of the requirements on closed portfolios should certainly be taken into account when developing the macro hedging model on open portfolios.
- In particular, we believe that the issue of net positions has not been properly addressed. Paragraph B73 in the Exposure Draft still requires the designation of gross amounts, which is not in line with the stated objective that is to align hedge accounting with risk management practice.

**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 proposals in the Exposure Draft. Doing otherwise would introduce a new measurement attribute.

**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?

Overall we agree with the proposed disclosures but:

- paragraph 43 of the Exposure Draft indicates that the entity shall determine how much detail to disclose in order to meet the requirements of paragraph 40 without referring to the information required in paragraphs 44 to 52. Instead, we believe that paragraph 43 should refer to 44 to 52 as minimum requirements, to which the entity can add information.
- disclosure on rebalancing is not explicitly required. We believe this information is important for the user of the financial statements. Such disclosure would provide valuable information on the adequacy, in reality, of the risk management strategy and on the unexpected sources ineffectiveness that arose retrospectively.
- disclosures should also include information on the residual un-hedged exposures to risks so that the user has a global overview of the risk management strategy of the entity. See also our answer to question 1.

**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?

Even though as a financial institution, we are not impacted by this proposal, we would like to mention that this is one of the cases where the entity's business model should play an influential role.

**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 believe that, in line with the objective of hedge accounting to reflect the risk management strategy of the entity, the hedge accounting model should provide the possibility to account for credit derivatives.
- There is no reason to single out credit as an unhedgeable risk. Indeed, let's consider an exposure to a counterparty and a CDS on the same counterparty, it could be that the exact trigger events under both contracts are different however, the offsetting between the fair value of any exposure and the fair value of the CDS will move in opposite direction and such offsetting will not be accidental. In such scenario, the optimal ratio could be different from 100%, exactly as can be the case when hedging commodities.
- Credit derivatives play an important role in the offsetting of risks (e.g. in the banking book) on assets held to collect contractual cash flows. Ignoring any possibility to perform hedge accounting in these cases jeopardises the general principle of aligning hedge accounting with the reality of economic hedging as foreseen by the entity's risk management strategy.

**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 on the appropriateness of prospective application but we believe that the effective date for transition to the new requirements should be later than 1 January 2013 also to allow entities to prepare for this transition. In particular, complex new rules such as rebalancing will require long education and systems set up delays.
- On the other hand, one should also consider the needs of those preparers that have valid reasons for an earlier adoption.