

## AMERICAN INTERNATIONAL GROUP, INC.



16 March 2011

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom  
[www.ifrs.org](http://www.ifrs.org)

**Via website posting:** <http://www.iasb.org/>

**Re: Exposure Draft Comment: Hedge Accounting (ED/2010/13)**

AIG appreciates the opportunity to comment on the Exposure Draft (“ED”), *Hedge Accounting* (the “Proposed Standard”). We support the International Accounting Standard Board’s (“IASB” or “the Board”) effort to improve and simplify hedge accounting by developing hedge accounting guidance that is aligned with an entity’s risk management practices. We agree with many of the proposals put forth in the ED. We also, however, believe there are several areas where the ED can be improved. Our comments and suggestions are summarized below and discussed in more detail in our responses to the IASB’s specific questions in the Appendix to this letter.

### SUMMARY COMMENTS

#### *Hedging Instruments*

We agree that non-derivative financial instruments measured at fair value through profit or loss should be permitted as eligible hedging instruments. In order to be consistent with this concept however, the range of eligible hedging instruments for hedge accounting should be extended to all financial instruments used in hedging strategies. That is, instruments measured at fair value through accumulated other comprehensive income that are used as part of an entity’s risk management strategy should be eligible hedging instruments. By permitting greater flexibility in the use of hedging instruments, the ED would better enable entities to more faithfully align their accounting with their risk management strategies and thus be consistent with the proposed objective of hedge accounting in the ED.

#### *Hedged Item—Aggregated Exposure*

We agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item. We believe this proposal is consistent with the objective of hedge accounting to align more closely with a company’s risk management strategies. We also welcome this proposal because there has been an implicit assumption at times by financial

statement users that if a derivative is not part of a designated hedging relationship, it must be being used for speculative purposes.

### ***Hedged Item—Risk Component***

We also agree with the proposed guidance that the appropriate level for designation is the risk component because it is consistent with the objective of the ED to align hedge accounting with an entity's risk management strategy.

For example, an interest rate swap is not designed to offset changes in cash flows that result from swap spread risk and credit spread and non-interest-rate components. Therefore, only the benchmark interest-rate component of the hedged debt instrument's cash flows should be analyzed to ensure the analysis is consistent with the economic function of the hedge – i.e., to hedge ("unlock") changes in fair value of the benchmark interest rate component cash flows of the hedged item. The objective of the hedge is not to hedge changes in the fair value of the overall hedged item due to only changes in a single underlying as one might infer based on the current guidance in IAS 39. We therefore welcome this clarity added to the proposed guidance.

### ***Hedge Effectiveness***

AIG assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. Regression analysis is often employed to assess the effectiveness of these hedges both on a prospective and retrospective basis. AIG does not utilize the shortcut method to assess hedge effectiveness. Given the operational complexity of application of the 80%-125% guidance in IAS 39, we welcome the proposal in the ED that hedge accounting and reporting should depict an entity's risk management objectives (and thus more accurately represent the economic substance of a hedge) rather than the form of the hedging relationship based on a set of stringent criteria. The bright lines that have developed around the current requirements in IAS 39 regarding "high effectiveness" often cause an inability to qualify for hedge accounting for a hedging relationship that an entity believes is necessary as part of a prudent risk management strategy.

### ***Rebalancing a Hedging Relationship***

We believe that the requirement to rebalance an existing hedging relationship as proposed under the ED is an improvement to the guidance in IAS 39, which requires hedge accounting to be discontinued. Economic realities of hedging relationships require flexible risk management techniques (such as adjusting hedge ratios) that can respond to dynamic markets. Therefore, guidance that recognizes the dynamic nature of certain hedging relationships by allowing the entity to treat the rebalancing as a continuation of the existing hedge is an improvement to the existing hedge accounting model.

However, we believe that rebalancing should be optional and not a requirement. Requiring rebalancing would be counter to the objective that hedge accounting should be aligned with an entity's risk management practices. Only in the event that a risk management strategy or objective has changed should a rebalancing be required.

### ***Disclosures***

While we agree that disclosures should help users identify how hedge accounting has affected the entity's financial statements, we are concerned that in the interest of "transparency" the proposed disclosures would provide information that is considered proprietary. That is, each entity has its own risk management strategies and views on markets and rates. To require an entity to disclose the percentage of total risk hedged, for example, could put companies at a competitive disadvantage. We therefore disagree with the assertion that a user needs to understand an entity's risk management strategy in detail in order to understand the accounting. Requiring an explanation of the risk management strategy for each category of risk provides insight into day-to-day management decisions that are not relevant to hedge accounting.

### ***Convergence***

The IASB and FASB are at different stages in their efforts to improve and simplify the guidance for hedge accounting. In addition, the two proposed hedge accounting models are diverged in significant areas such as nonderivatives used as hedging instruments, permitting standalone derivatives as hedged items, and hedging groups of items with offsetting risks. We hope that this ED can expedite the discussion on the key areas for improvement for both Boards. Further, we suggest that both Boards begin redeliberations simultaneously once the comment period for the FASB discussion document (*Selected Issues about Hedge Accounting*) has ended. In order to achieve a high-quality global standard on hedge accounting the Boards must strive to resolve these existing conceptual differences in a timely and collaborative manner.

### ***Field Testing***

Should the Board move forward with the Proposed Standard substantially as written, we suggest field tests of the proposals across a broad range of constituents be conducted to ensure that a final standard is well understood and can be appropriately implemented by entities who seek to achieve hedge accounting.

AIG is exposed to market risks, primarily within its insurance and capital markets businesses, and is a frequent user of derivatives and hedge accounting. As such, we would be pleased to provide any assistance needed by the Board.

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Our responses to questions raised by the IASB of importance to AIG are included in the Appendix to this letter. Thank you for the opportunity to present our views. Please do not hesitate to contact me at (212) 770-8997 if you have any questions or need clarification with respect to any matters addressed in this letter.

Very truly yours,

/s/Tom Jones

Director and Global Head of Accounting Policy  
American International Group, Inc.

cc: Anthony Valoroso  
Vice President and Chief Accounting Officer  
American International Group, Inc.

Ms. Leslie Seidman  
Financial Accounting Standards Board

## **APPENDIX**

### **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 that hedge accounting should represent the effect of an entity's risk management activities that use financial instruments to manage exposures arising from risks affecting profit or loss. A principles-based approach focusing on an entity's risk management activities is, in our view, the most appropriate basis for a hedge accounting model. We believe that hedge accounting and reporting should depict an entity's risk management objectives (and thus more accurately represent the economic substance of a hedge) rather than the form of the hedging relationship based on a set of stringent criteria. The bright lines that have developed around the current requirements in IAS 39 regarding "high effectiveness" often cause an inability to qualify for hedge accounting for a hedging relationship that an entity believes is necessary as part of prudent risk management strategy.

We do, however, believe that there are two areas that can be clarified in the ED. The first relates to the level at which a risk management strategy is applied. AIG applies its risk management strategies at both a macro and micro level. That is, we may choose to mitigate risk at the individual transaction level or on a broader group/portfolio level. The hedge at the transaction level may also be in line with a risk management strategy at the macro level. Our understanding is that we have the flexibility to define our risk management strategy for each hedging relationship but would suggest the Board clarify this in Appendix B of the ED.

The second relates to flexibility in the election of hedge accounting for a hedging relationship. For example, an entity's risk management objective for interest-bearing assets and liabilities might be to convert fixed-rate liabilities to floating to match its floating-rate assets. We suggest the Board clarify whether the ED would require us to designate all fixed-rate liabilities as hedge items or if we would have the ability to apply hedge accounting only on selected fixed-rate liabilities.

### **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 measured at fair value through profit or loss should be permitted as eligible hedging instruments. In order to be consistent with this concept however, the range of eligible hedging instruments for hedge accounting should be extended to all financial instruments used in hedging strategies. That is, instruments measured at fair value through accumulated other comprehensive income that are used as part of an entity's risk management strategy should be eligible hedging instruments. For example, in AIG's insurance

operations, the asset-liability exposures are predominantly structural in nature, and not the result of speculative positioning to take advantage of short-term market opportunities. The asset and liability profiles are managed so that the cash flows resulting from invested assets are sufficient to meet policyholder obligations when they become due without the need to sell assets prematurely into a potentially distressed market. The assets used in this hedging relationship (e.g., corporate debt securities classified in AFS) would be ineligible for hedge accounting under the ED. This is in direct contrast to the stated objective that hedge accounting should represent the effect of an entity's risk management activities that use financial instruments to manage exposures arising from risks affecting profit or loss. We note that in paragraph BC39, the Board views using a hedging instrument that is measured at fair value through accumulated other comprehensive income as inconsistent with the decision to not allow hedge accounting for investments in equity instruments designated as fair value through other comprehensive income. We do not believe the comparison is at all similar. In fact, by making nonderivatives ineligible for use as hedging instruments, the Board is creating an exception to the principle in the ED that the objective of hedge accounting is to resolve asymmetry in recognition and measurement of a hedge relationship.

### **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 that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item. We believe this proposal is consistent with the objective of aligning hedge accounting more closely with a company's risk management strategies. In many instances, risk management strategies consider aggregated exposures in which the risk of a cash instrument is combined with the risk of a derivative. We point to the example provided in paragraph B9 regarding 10-year fixed rate debt denominated in a foreign currency. In that example, the entity requires fixed rate interest exposure in its functional currency for two years, with floating rate exposure in its functional currency for the remaining term to maturity (eight years). To achieve this, the entity will enter into 1) a 10-year fixed-to-floating cross-currency interest rate swap to hedge the foreign currency risk and 2) an interest rate swap (in its functional currency) to convert the short-term interest rate exposure from a floating to a fixed rate. In effect, the entity has converted its fixed rate foreign currency exposure to fixed rate functional currency debt for the first two years and floating rate functional currency debt for the remaining eight years. Under the current guidance in IAS 39, the entity would be required to designate the cross-currency swap as a hedge of foreign exchange risk only while the interest rate swap is a hedge of interest rate risk only. This common risk management strategy will result in an overstatement of hedge ineffectiveness under IAS 39 on the cross-currency interest rate swap. This result can be misleading to users of financial statements because it could seem to a reader that the entity did not properly manage its risks. Therefore, we agree with the proposal on hedging aggregated exposure as it would align the hedge accounting with that of the entity's risk management strategy.

We also welcome this proposal because there has been an implicit assumption that if a derivative is not part of a designated hedging relationship, it must be being used for speculative purposes. AIG uses derivatives and other financial instruments as part of its financial risk management programs. In managing interest rate risk for example, AIG may choose to offset an exposure created by an interest rate swap by using a fixed income security or other interest-rate-sensitive assets and liabilities. The non-derivative financial instruments are effective economic hedges of the derivative exposures they are meant to offset.

**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 (i.e., 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 agree that the appropriate level for designation is the risk component because it is consistent with the objective of the ED to align hedge accounting with an entity's risk management strategies.

**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 that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item. Risks that are separately identifiable and reliably measurable should be allowed to be designated as a hedged item. As discussed in our response to Question 4, we believe this will more closely align the accounting for a transaction with the economics and risk management strategy.

(b) We do not agree with the exception in paragraph B23 that prohibits a layer component containing a prepayment option if that option's fair value is affected by changes in the hedged risk from being eligible as a hedged item in a fair value hedge. US GAAP currently allows an instrument with a prepayment option to be a hedged item in a hedging relationship provided there is a mirror option on the hedging instrument. We believe that hedge accounting concept is well understood and widely used in practice and suggest that the Board consider converging in this area with US GAAP.

In our view, this is inconsistent with the concept in paragraph 18 regarding designation of a layer as a hedged item. Provided the risk component can be separately identified and reliably measured we see no reason to prohibit designation of a layer component that includes a prepayment option because it is inconsistent with a principles-based standard that seeks to reduce exceptions (that is, there are no “exceptions” to principles; only exceptions to rules). We also believe this conflicts with the Board’s comments in paragraphs BC59-60 on what was learned from outreach activities regarding risk components; i.e., that “...entities are able to identify and measure with sufficient reliability many risk components....”

Therefore, we suggest that the Board strike the specific rule in paragraph B23 prohibiting a layer component that includes a prepayment option from being eligible to be a hedged item in a fair value hedge if its fair value is affected by changes in the hedged risk.

#### **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?**

AIG supports the qualifying criterion in paragraph 19 that the hedging relationship must meet the hedge effectiveness requirements. We believe the hedge effectiveness requirements in paragraphs B27-B39 are an improvement to IAS 39 and are more consistent with a principles-based approach to hedge accounting. Specifically, we welcome the removal of the bright line (80% – 125%) guidance. This will significantly reduce the operational burdens resulting from the required quantitative analysis for achieving hedge effectiveness in IAS 39. This will also result in fewer de-designations for hedging relationships that are economically sound but intermittently run afoul of the 80%-125% test.

We also support the “other than accidental offsetting” criterion, and note that this is again in line with the objective of aligning an entity’s accounting with its risk management strategy. In our view, a hedge that is economically designed to mitigate risks should always be eligible for hedge accounting. However, we are concerned with the lack of clarity as to how an entity might identify offsetting that is other than accidental. We therefore suggest an additional example to clarify the Board’s intent in order to mitigate the development of quantitative bright-lines regarding correlation.

#### **Question 7**

- (a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?**
- (b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?**



(a) We believe that the requirement to rebalance an existing hedging relationship as proposed under the ED is an improvement to the guidance in IAS 39, which requires hedge accounting to be discontinued. Economic realities of hedging relationships require flexible risk management techniques (such as adjusting hedge ratios) that can respond to dynamic markets. Therefore, guidance that recognizes the dynamic nature of certain hedging relationships by allowing the entity to treat the rebalancing as a continuation of the existing hedge is an improvement to the existing hedge accounting model.

However, we believe that rebalancing should be optional and not a requirement. Requiring rebalancing would be counter to the objective that hedge accounting should be aligned with an entity's risk management practices. Only in the event that a risk management strategy or objective has changed should a rebalancing be required.

(b) We believe that if an entity expects that a designated hedging relationship will fail to meet the objective of the hedge effectiveness assessment in the future, rebalancing is appropriate.

#### 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?**

(a) We disagree that an entity should only discontinue hedge accounting when it no longer reflects the entity's risk management strategy.

(b) We believe that an entity should 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 because this will result in companies unnecessarily incurring additional costs to enter into offsetting hedging transactions when de-designation would have been the more cost-effective approach.

#### 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 recognized in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?**

- (b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?**
- (c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?**

- (a) We disagree with the proposal in the ED that the recognition of the gain or loss on the hedging instrument and hedged item in a fair value hedge be recognized in other comprehensive income merely because it allows for the effects of risk management activities for both cash flow and fair value hedges to be presented in one place (OCI). We do not believe recording the fair value changes through OCI is beneficial because the net impact in OCI at any date would be zero. Further, this change will increase operational complexity for what we perceive to be of no benefit. The net result in the income statement will be the same as under existing guidance but the mechanics will change by adding a separate step. We believe that the current recognition model for fair value hedges provides less complex accounting for preparers and more relevant information to financial statement users.
- (b) We see no benefit to separate balance sheet presentation of the gain or loss on the hedged item attributable to the hedged risk. This seems to add unnecessary complexity to financial statement reporting. While we recognize that the Board's rationale in paragraph IN30 attempts to eliminate a mixed measurement of the hedged item on the balance sheet, we believe that readers understand this measurement given the extensive disclosures provided. We suggest that the Board better articulate its rationale for this reporting requirement and why this is a disclosure that users require. We therefore recommend that the separate fair value hedged item adjustment instead be provided in the notes to the financial statements.
- (c) We agree that linked presentation should not be allowed for fair value hedges. A linked presentation would not result in more appropriate totals of assets and liabilities and would not differentiate between the types of risk that are covered by a particular relationship and those that are not. In our view, it is most appropriate instead to provide hedging information in financial statement disclosures that allow users to assess the relevance of the information for their own analysis.

**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 (e.g., like a basis adjustment if capitalized 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 (i.e., the ‘aligned time value’ determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?**

(a) We support that the Board is converged with the FASB on recording an option’s time value in accumulated other comprehensive income.

(b) We agree with the proposal in the ED that the time value in a fair value hedge for period-related transactions should be amortized from accumulated other comprehensive income to earnings.

(c) We do not 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. In our view it is operationally complex to consistently identify the “aligned time value” for hedges where the critical terms may not always match. In addition, moving to an approach that uses requirements for critical terms of the option and the hedged item is unnecessarily rule-based and at times will be counter to how an entity manages its risk.

#### **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 in paragraph 34 of the ED for groups of items as the hedged item because they are more closely aligned to a company’s risk management practices. Overall, we believe the removal of the restriction in IAS 39 regarding application of hedge accounting for groups of items to be an improvement to the hedge accounting model.

We would, however, appreciate additional clarity on the implementation of the condition in paragraph 34 (c) that only offsetting cash flows that affect profit or loss in the same period can be grouped as the hedged item. What if the timing of the one of the gross cash flows hedged as part of a net position changed such that all cash flows did not occur in the same reporting period? Our concern is that this requirement could be interpreted to disqualify hedge accounting from initial designation (i.e., the hedged group never met the criteria to be considered a hedge item).

#### **Question 12**

**Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (e.g., in a net position hedge), any hedging instrument gains or losses recognized 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 that it is inappropriate to gross up the gain or loss on the hedging instrument for each affected income statement line item in a hedge of a group of items. However, we disagree that the gain or loss in a hedge of a group of items should be reported in a separate line item. We believe companies should have the flexibility to present the gain or loss on the hedging instrument in a manner that best reflects the objective of the hedging strategy.

**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?**

While we agree that disclosures should help users identify how hedge accounting has affected the entity's financial statements, we are concerned that in the interest of "transparency" the proposed disclosures would provide information that is considered proprietary. That is, each entity has its own risk management strategies and views on markets and rates. To require an entity to disclose the percentage of total risk hedged, for example, would put companies at a competitive disadvantage. We therefore disagree with the assertion that a user needs to understand an entity's risk management strategy in detail in order to understand the accounting. Requiring an explanation of risk management strategy for each category of risk provides insight into day to day management decisions that are not relevant to hedge accounting.

**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?**

This is not relevant to AIG's business and we have no comment.

**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 there should not be a separate accounting treatment for hedges of credit risk using credit derivatives. Provided the risk component is separately identifiable and reliably measurable, eligibility for hedge accounting is consistent with the objective of hedge accounting in the ED. We therefore believe that further guidance on this topic is not needed as it will add to the complexity of the proposed ED.

**Question 16**

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

AIG agrees with the proposed transition requirement to adopt final guidance prospectively. Alternatively, the Board could consider allowing all hedging relationships that meet the current requirements in IAS 39 to be “grandfathered” upon adoption and allow companies to de-designate those relationships in subsequent periods if certain of those relationships fail to meet the new requirements or are otherwise no longer aligned with an entity’s risk management strategy.