



FEDERATION  
BANCAIRE  
FRANCAISE

*Banking supervision  
And Accounting issues Unit  
The Director*

Paris, March 9th 2011

**FBF Response to the Exposure Draft "HEDGE ACCOUNTING"**

Dear Sir,

The French Banking Federation (FBF) welcomes the opportunity to comment on the Exposure Draft "Hedge Accounting".

The FBF supports the general direction of the hedge accounting model as it aims to align more closely hedge accounting with the risk management activities of an entity and to establish a more principle-based approach of hedge accounting.

However, we lack of elements allowing us to fully comment on to the proposal. The ED rather focuses on hedge accounting issues for non-bank corporations in the context of one-to-one hedging relationship. It has excluded from its scope macro hedging and hedging of an open portfolio, two main issues for the banking industry. We would encourage the IASB to re-expose all aspects of the general hedge accounting model when it would complete its work on phase 2.

We note some positive points of the ED such as: reference to risk management strategies, the simplification of the hedge effectiveness assessment and the elimination of the 80-125 bright-line, the approach by components, the revaluation of both sides of the hedge in a fair value hedge, and the amendment to the notion of groups of hedged items. As far as internal derivatives are concerned, we understand from the ED and notably from paragraph BC45 that although internal derivatives should not be eligible hedging instruments, related requirements in IAS 39 would be retained and, accordingly, provisions related to internal derivative contracts used to centralize risk exposures in order to transfer them to a third party with an external derivative would be retained.

**Sir David TWEEDIE**  
**Chairman**  
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However we have serious concerns on several areas we believe that should be improved. We would like to focus on the following issues:

- The sub-Libor issue, including the identification as hedged items of core deposits as a source of interest rate risk. It should be addressed in the second phase, considering risk management practices endorsed by regulators such as the Basle Committee.
- The exception set by paragraph B 23 to exclude the bottom layer approach for groups of items containing contracts with prepayment options where the option's fair value is affected by changes in the hedged risk.
- The prohibition of designating equity instruments at fair value through other comprehensive income as hedged instruments as economically they are part for an entity's risk management activities. So it is inconsistent to recognize that these strategies are well grounded and to exclude them in practice in the precise circumstances where they are implemented.
- The prohibition of hedging credit risk : Credit risk management is crucial for the banking industry. Using credit derivatives to manage credit risk is a common risk management strategy for financial institutions. The opinion expressed in the BC is rule-based and therefore not in the spirit of a principle-based approach to setting accounting standards. CDS are effective tools for transferring that risk to counterparts and, properly used, achieve other than accidental offsetting between the asset held and the derivative in the event of default. We acknowledge that there are some issues to be dealt with notably those linked to CDS fair value changes due to factors other than the credit rating of the obligor. Nevertheless solutions to these obstacles can be found so that we can recognize in the financial statements a basic risk management strategy.

In addition, the following concepts should be clarified *inter alia*:

- The concepts of "unbiased" result produced by a hedge relationship
- The concept of rebalancing (versus de-designation/re-designation);
- The consequences of the designation of net positioning the documentation process
- The consequences of the designation of derivatives as hedged items, regarding their accounting status

Our detailed responses to the questions in the ED are included in the Appendix to this letter. We will be pleased to give you any further information that you may require.

Yours Sincerely



Jean-Paul Caudal

## **APPENDIX**

### **Objective of hedge accounting (paragraphs 1 and BC11–BC16)**

#### **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 welcome the principle-based approach adopted by the ED and the objective which establishes a link between hedge accounting and the entity's risk management strategies. We welcome as well that hedge accounting should not be mandatory but based on a voluntary designation.

However, excluding some hedging transactions (e.g. sub Libor issue, exception to the bottom layer approach of the paragraph B23) from hedge accounting ignore the risk management strategies and render the risk management objective stated in the ED entirely ineffective.

We do not agree with the restriction to apply hedge accounting to risks that affect profit and loss only and therefore prohibits designating items that are recognised through the statement of comprehensive income without recycling to profit and loss (e.g. equity instruments at fair value through OCI) as hedged items.

We believe that hedge accounting should also be extended to hedged risks that do not affect profit and loss as economically such hedges are part for an entity's risk management activities and as it is common practise to hedge such items. We note that items that are recognised through the statement of other comprehensive income without recycling to the profit and loss contain components representative of the profit and loss. There are no conceptual reasons to accord more primacy to one part of the statement of performance over the other. We advocate the IASB to reconsider its position on the topic.

### **Instruments that qualify for designation as hedging instruments (paragraphs 5–7 and BC28–BC47)**

#### **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 eligible as hedging instruments

However, we see no conceptual basis for not allowing, as hedging instruments, any non-derivative financial instruments not measured at fair value through profit or loss. We believe that the range of non-derivative financial instruments should be extended to those not measure at fair value through profit and loss as this might be consistent with the entity's risk management strategy and the objective of hedge accounting.

The ED is internally inconsistent saying in one side that no difficulties arise in identifying non-contractual components designated as the hedge items and on the other side that non-contractual components in hedging instruments could not be measured reliably. We suggest the IASB to explore further this issue.

**Derivatives that qualify for designation as hedged items (paragraphs 15, B9 and BC48–BC51)**

**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 synthetic exposures comprising derivatives are eligible hedged items as this will better reflect the risk management strategies in the financial statements in accordance with the objectives of the proposals.

However, given the impacts on portfolio hedging, further guidance should be provided on the following issues:

- Should the derivative part of the exposure be considered as trading or hedging instrument?
- Could two risks hedged simultaneously (e.g. interest rate risk and forex) be considered as one global exposure?
- How to account for the risk hedged on both the derivatives (presumably on fair value basis) and the cash instruments (at cost) when only risk arising from a component of the exposure is hedged?
- Additionally, with regard to the qualification for designation as hedged items (paragraphs 12-14), we would like to mention that the final standard should allow to qualify the forecast results of a subsidiary as a hedged item, doing so hedge accounting would be aligned with the entities risk management strategies and volatility in the P&L account due to the translation risk, would be avoided.

**Designation of risk components as hedged items (paragraphs 18, B13–B18 and BC52–BC60)**

**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 agree that risk components should be eligible hedged items if the risk component is separately identifiable and measurable as this reflects how risks are hedged in practice.

However, we note that a designated component must be less than equal to the total cash flow of the asset or liability. This rule is in contradiction with the overall principle of hedge accounting to be aligned with the risk management practice.

Financial institutions commonly use benchmark rates (e.g. Libor/swap rates) to price assets or liabilities. The spread of the benchmark rate may or may not be included in the risk management strategy. We strongly believe that the hedge accounting designation should follow the risk management, so that either the Libor component or the total cash flows of a sub-Libor instrument can be designated, rather than adopting specific rule-based restrictions.

Allowing sub Libor hedges to be designated on a risk components basis is not inconsistent with the instrument being hedged in a true margin hedge of a liability. This will delete an inconsistency in the existing IAS 39 risk component approach for hedging, as asset and liabilities are priced in financial markets in the same ways and accounting hedging requirements are different.

The issue of the sub-Libor is crucial for the financial institutions as it is at the very core of their activities. It should be discussed in depth when developing the second phase of the hedging project.

We recommend that

- the requirements that prevent from hedging below 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 is principle-based and consistent with its stated intent to be aligned with actual risk management.

Concerning the matter of inflation, we do not agree with B18 which states that inflation cannot be designated as a risk component of a financial instrument unless it is contractually specified. Determining whether it is possible to separately identify and reliably measure inflation as a risk component should be left to the entity judgment. Furthermore, no difference should be made in inflation risk which is explicitly or implicitly specified. Finally, no such restriction exists for non-financial items which results in an inconsistency with the treatment for financial items.

#### **Designation of a layer component of the nominal amount (paragraphs 18, B19–B23 and BC65–BC69)**

##### **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 that layers of the nominal amount of an item can be designated as hedged items as it portrays accurately an entity's actual risk management practices.

b) However, we are strongly opposed to the exclusion of contracts with prepayment options from designation as hedged items. We disagree that a prepayment option as stated in paragraphs B23 and BC69 is not eligible to be designated as a hedged item on the basis that the risk component cannot be separately identified. This exclusion would not align activities of entities that are considering prepayment options in their business with the economic risk management and, accordingly, does not properly reflect the effect of a prepayment option in accounting.

An entity should be allowed to designate a layer of the nominal amount of an item with a prepayment option as the hedged item.

The reasoning developer under paragraph BC69 could be applied to a one to one relationship because the behaviour of a loan with an embedded prepayment option is not predictable, so the whole range of possibilities must be included in the option valuation. But we disagree it can apply to group of hedged items or to portfolios.

In a portfolio (either closed or open) approach, the behaviour of customers is taken into consideration globally. Based on historical data a stable portion of prepayable loans is

identified as bottom layer loans not affected by these prepayment options. Therefore the value of the prepayment option can be considered as nil.

Hedging prepayments risks via underhedging (i.e. designating a bottom layer of loan portfolios) is a risk management strategy commonly undertaken by financial institutions

We see a contradiction between allowing entities to rebalance their designations so as to comply with the accounting rules and prohibiting bottom layer to be hedgeable. Excluding bottom layer is inconsistent with the objective of the ED requiring that the hedging relationship should be in line with risk management strategies.

**Hedge effectiveness requirements to qualify for hedge accounting (paragraphs 19, B27–B39 and BC75– BC90)**

**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 hedge effectiveness requirements and the removal of the 80-125% test. We also support the elimination of the retrospective effectiveness testing.

We welcome B34 which states that "... 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 produced a biased result".

We welcome BC 38 which states that an "entity's risk management is the main source of information to perform the assessment whether a hedging relationship meets of the hedge effectiveness requirements".

From those two paragraphs we understand that the board's objective was to allow the hedging relationship fluctuating within the parameters defined by the risk management strategy and that the hedge relationship will be only re-balanced as and when the risk management limits are breached or about to be breached.

Paragraph B29 introduces a new notion of "unbiased" result. It requires ensuring "that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness". The term "unbiased" is unclear and could be narrowly interpreted and hence could be inconsistent with the objective of hedge effectiveness assessment and the risk management judgment.

Requiring that a hedging relationship must produce an "unbiased" result and minimize expected hedge ineffectiveness seems to focus effectiveness assessment on the hedge ratio. It is not clear whether the ED intends that hedge effectiveness must be assessed for a hedging relationship that is considered to be 100% effective for risk management purposes. This not consistent with the way risk management strategy is driven as hedging relationship is managed within risk limits and is not rebalanced systematically as long as it remains within these defined limits.

## **Rebalancing of a hedging relationship (paragraphs 23, B46–B60 and BC106–BC111)**

### **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?*

We support the concept of rebalancing as it might avoid irrelevant dedesignation and redesignation of hedging relationships and as it would reflect the economics of a dynamic hedging strategy

However, the concept of rebalancing is rather complex and may create confusion and difficulty in practice in applying the distinction between rebalancing and discontinuation. Prohibiting voluntary dedesignation of a hedged item when risk management objectives remain the same would be in contradiction with the concept of rebalancing and the provisions of paragraph 23. Indeed when the hedging instrument does not meet any more the objective of the hedge effectiveness and when the objective of management is unchanged, the hedging relationship shall be rebalanced. De-designation would then be possible.

Rebalancing is a matter of fact based on risk management strategy rather than a matter of accounting.

## **Discontinuing hedge accounting (paragraphs 24, B61–B66 and BC112–BC118)**

### **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 agree discontinuing hedge accounting when the qualifying criteria are not longer met.

b) No conceptual reasons justify not allowing voluntary discontinuation of hedging relationship when this reflects the entity's hedge accounting strategy. As initiating a hedging relationship is voluntary, symmetric accounting treatment should be permitted for dedesignation in order to appropriately reflect in the financial statements the entity's dynamic hedging strategy.

## **Accounting for fair value hedges (paragraphs 26–28 and BC119–BC129)**

### **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?*

a) We do not support the two-step approach for recognition of gains and losses in OCI and then a transfer of any ineffectiveness to the profit or loss account as we do not believe that additional line items would add value to users. We favour a one-step approach where any ineffectiveness is recognised immediately in profit and loss.

b) The proposal of the ED would lead to numerous new line items in the statement of financial position if separate presentation is required by category of hedged item and by hedged risk. Clarity of the statement of financial position would not be improved. Therefore we propose to have a single line in the statement of financial position where all fair values adjustment would be recognised. The link between the gross amounts of total hedge adjustments and the relevant asset or liability should be provided in the disclosures.

c) We agree that linked presentation should not be allowed for fair value hedges.

## **Accounting for the time value of options for cash flow and fair value hedges (paragraphs 33, B67–B69 and BC143–BC155)**

### **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?*

(a) We 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.

(b) We agree with the proposal related to the part of the aligned time value for period related hedged item.



(c). We believe the requirement of "aligned time value" is complex in practice and would not portray accurately the relationship between the hedged exposure and the optional hedging instrument. We suggest continuing further analysis in order to simplify the accounting treatment.

**Hedges of a group of items (paragraphs 34–39, B70–B82 and BC156–BC182)**

**Eligibility of a group of items as the hedged item (paragraphs 34, B70–B76, BC163, BC164 and BC168–BC173)**

**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?*

Eligibility for group of hedged items seems to be simplified compared to the IAS 39 provisions. We welcome the ED to permit hedge accounting for net positions as it better reflects an entity's risk management.

However, we need to see the proposal for macro hedging before providing a more comprehensive answer concerning the group of items.

We believe that the criteria defined for the closed portfolios should be reviewed when developing an accounting framework for open portfolios and when considering the achievement of the hedge accounting objective (reflecting risk management hedging strategies in the financial statements).

**Presentation (paragraphs 37, 38, B79–B82 and BC174–BC177)**

**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 regarding the presentation in profit or loss of the effects of hedge accounting for group of items notably with the proposal to present on a net basis in a separate line item in profit or loss, the gains or losses from the hedging instrument.

However, requiring on the face of balance sheet "the gain or loss to be presented on a gross basis next to each line item that includes the related asset or liability" would result in an increasing number of line items on the balance sheet. We would recommend the fair value changes should be aggregated into a single line item and relevant information could be provided through appropriate disclosures.

## **Disclosures (paragraphs 40–52 and BC183–BC208)**

### **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?*

(a)- We agree with the principle based approach and with the general objectives for disclosure including information on the entity's risk management strategy, its hedging activities and the effect of hedge accounting on the financial statements.

However, we question the relevance of the granularity and the volume of the quantitative information required for each type of risk and category of hedge.

We would recommend a review of the disclosures required compared to the existing disclosures in IFRS 7 and eliminate those disclosures which do not provide useful information. An appropriate cost / benefit analysis should also be run to avoid disclosure burden for preparers with no added value for users.

b) We believe the disclosures should not be too prescriptive but sufficiently flexible to allow entities to portray accurately their risk management strategies.

The disclosures should be reviewed upon the question of the linkage between risk management and hedge accounting is known after phase 2.

### **Accounting alternatives to hedge accounting (paragraphs BC208–BC246)**

#### **Accounting for a contract for a non-financial item that can be settled net in cash as a derivative (Appendix C and paragraphs BC209–BC218)**

### **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?*

We believe that accounting contracts settled net in cash for as derivatives when in line with the entity's fair value based risk management strategy would resolve a practical issue. Therefore we agree on the proposal.

### **Accounting for credit risk using credit derivatives (paragraphs BC219–BC246)**

### **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?*

a) We do not agree with any of these three accounting alternatives. They are complex and rather rule-based as an exception to a principle-based approach for a standard on hedge accounting.

b) As describes in paragraph BC219 financial institutions currently use credit derivatives to manage their credit risk exposures arising from their lending activities.

However, paragraph BC220 prohibits using credit default swaps for hedge accounting because of the difficulty to isolate and measure the credit risk component.

Not allowing hedge accounting in these cases contradicts the general principle stated in the ED of aligning hedge accounting with the entity's risk management strategy and practices and the possibility of the designation of a risk component as being hedged.

Moreover, saying that an entity is unable to assess the hedge effectiveness contradicts also paragraph B33 which stated that method of assessing hedge effectiveness is under the scope of the entity.

Finally, the assertion that credit risk is not an eligible risk component contradicts requirements of other projects or standards such as reporting for changes in own credit risk for liabilities where the effect of changes in credit risk is required to be recognized in OCI.

We believe that hedge accounting should be permitted regardless of the type of hedge as far as an entity demonstrates that the hedge relationship is effective relating to credit default event.

#### **Effective date and transition (paragraphs 53–55 and BC247–BC254)**

##### **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 mentioned in our comment letter on request for views on effective dates and transition methods, we are in favour of adopting at the same effective date all the expected standards related to the IAS 39 reform as they are the cornerstones of the financial reporting under IFRS. An early adoption should not be permitted.

We suggest an effective application date no earlier than 1st January 2015 as a three year period is required to implement the new standard. Should any standard be issued after the expected date of end of 2011, the effective date of all the standards should be postponed proportionately to the delay.

A full retrospective application would be unrealistic due notably to the major IFRS changes entities should face, the scope of financial instruments involved, data to be collected and hypothesis to be formulated in order to restate past transactions. Accordingly, we suggest applying a mechanism similar to the one applied for the transition to IAS 39 for first time adopters in 2005. The opening balance sheet should be restated with a reconciliation schedule between closing and opening balance sheets.