



909 Third Avenue
New York, NY 10022

9 March 2011

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

Re: Exposure Draft: Hedge Accounting ED/2010/13

Citigroup appreciates the opportunity to respond to the Exposure Draft: *Hedge Accounting* (ED or the proposal). Overall, we are supportive of the IASB's proposal to better represent the risk management activities of the reporting entity in the hedge accounting models. However, we have concerns that the ED presents a hedge accounting model which is too restrictive to be able to properly reflect in the financial statements many common risk management strategies employed by financial institutions. The rules surrounding de-designation and rebalancing of hedge accounting relationships are unnecessarily complex and restrictive and will be very difficult to apply in practice. As such, the proposal, whilst being a strong step forward in many areas, does not achieve its stated objectives. Our further comments are outlined in greater detail through responses to the specific questions raised in the ED.

Citigroup strongly supports full convergence of IFRS and U.S. GAAP, in particular on the accounting for financial instruments. Convergence should remain a priority, and we urge the IASB and FASB to work together to finalize the hedge accounting guidance.

We would be pleased to discuss our comments with you at your convenience. Please feel free to call me in New York at (212) 559-7721.

Sincerely,

A handwritten signature in blue ink that reads "Robert Traficanti".

Robert Traficanti
Deputy Controller and Global Head of Accounting Policy
Citigroup Inc.

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 in principle with the overall objective of hedge accounting “to represent in the financial statements the effects of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss.” However, we are concerned that this objective fails to acknowledge the differences between risk management and hedge accounting. Hedge accounting only represents a portion rather than the entire risk management of a reporting entity. The role of hedge accounting, which is based on management’s election, is to help align the accounting treatment with certain risk management activities of the reporting entity, and help reflect the economics of those risk management activities where the accounting rules for the specific instruments would otherwise create an accounting mismatch. We have two primary comments where the proposals in the Exposure Draft do not meet the objectives and should be amended.

Certain Restrictions on Hedge Accounting are Inconsistent with the Objectives

As currently drafted, the proposal contains too many restrictions to represent adequately many common risk management practices of financial institutions. We believe that the model should be fully principles-based and permit hedging strategies which are widely used in the risk management practices of reporting entities, but which are not currently accepted in the accounting literature. In particular, the ED takes the view that credit risk is not a separately identifiable or reliably measurable risk and thus is not eligible for hedge accounting. Many financial institutions use Credit Default Swap (CDS) contracts to manage the credit risk of loan assets held on balance sheet. Credit risk is clearly a component risk within loan exposures, and the primary purpose of the derivative trades is to manage risk in the loan book. Credit risk is currently isolated, measured, and (for many U.S. GAAP reporters) separately disclosed for derivatives and debt instruments accounted for at fair value (commonly referred to as credit valuation adjustments (CVAs) for counterparty and own credit non-performance risk). Since financial institutions can and are required to separately disclose CVA on complex derivatives and structured notes, it is possible to isolate credit risk on most loans. As such, we believe that credit exposures in loan books are separately identifiable and reliably measurable and should be eligible within this framework as hedged items. We would compare this with, for example, a hedge of crude oil prices as a component in the pricing of jet fuel, which the ED explicitly permits although similar valuation judgments are necessary.

More fundamentally we think the final model should permit judgment in this area and not explicitly permit or prohibit certain hedging strategies. Using a principles-based approach, there will be less need for specific exceptions (for example, those discussed in BC226 for hedges of credit risk) which only serve to further complicate an already complex area. Refer to Questions 4 and 15 for more details.

Hedge Accounting Dedesignation Should be Elective

The proposal to require constituents to prove that the risk management strategy has changed in order to dedesignate a hedge accounting relationship is not operational or auditable. Current IAS 39 hedge accounting guidance in this area permits voluntary dedesignation and has not caused issues in practice.

In practice, hedge accounting must be elective because it is not possible to prescribe which risk management activities must be aligned or tied to hedge accounting. The Board does not specify in the ED the required level at which the ‘risk management objective and strategy’ should be documented or hedge accounting should be applied. We do not believe it would be possible to do so, because risk management is performed at many different levels and is not (and should not be) directly tied to accounting rules. The risk management and risk tolerances for a specific “desk” or business within a financial institution may be different than the overall objectives and strategies for the regulated legal entity, segment, or consolidated group. Similar issues arise for corporate entities. The Board appears to acknowledge that there are difficulties in this area when referring to discussions of whether disclosures should be required for economic hedges (i.e., those contracts which mitigate risk, but which are not subject to hedge accounting) in BC205-207 of the Basis for Conclusions. The relevant paragraphs state that it would be difficult for the Board to determine “which part of an entity’s risk management was relevant for the purpose of this disclosure and then define this part to make the disclosure requirement operational. The Board did not believe that this was feasible as part of its hedge accounting project but would have a much wider generic scope.” We note that this difficulty is not restricted to economic hedging and disclosures, but is equally applicable to those risk management activities which are eligible for hedge accounting.

Given that disparity will and must continue to exist between risk management strategies and accounting, we would request that the objective of hedge designations be based upon an accounting decision within the framework of the overall risk management strategy, rather than simply to reflect the overall risk management strategy. This would better marry the objectives of the ED with the current proposals contained therein. It would also reduce the exceedingly complex proposals around de-designation and rebalancing that we believe will cause countless implementation issues and reduce consistency of application in practice.

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 in principle but think the practical applications of this will be limited.

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 strongly support this proposal in principle, but request further clarification to explicitly state the accounting models which should be applied to the aggregated instruments. For example, assume a reporting entity owns a 10-year fixed-rate bond accounted for at amortized cost, and enters into an interest rate swap for the entire 10 years (pay fixed, receive floating). Further assume that the reporting entity wants to fix its interest receipts for the first 2 years, and therefore executes an interest rate swap with a 2-year tenor (receive fixed, pay floating). The ED would permit the reporting entity to designate the aggregated 10-year bond and 10-year interest rate swap as an exposure that is eligible for hedge accounting.

It is not clear in the ED, however, whether the bond and 10-year swap should be accounted for as a synthetic floating-rate instrument, at amortized cost, or under the usual hedge accounting models. We note certain publications commenting on the ED state that combined synthetic instrument accounting may be the Board's intended result. Also, if combined synthetic instrument accounting is initially applied, it is not clear in this example what the accounting should be for the combined instrument (10-year bond and 10-year swap) after the 2-year hedge expires. Assuming that the entity decides not to hedge the combined instrument after the first 2 years, we assume that the combined instrument would then have to be broken up and appropriate accounting applied on an individual instrument basis. The 10-year interest rate swap with 8 years then remaining would be subject to fair value accounting, resulting in an earnings adjustment from amortized cost to fair value. Such a financial statement impact that would occur as a result of the expiration of the 2-year hedge seems very counterintuitive.

In our view, each derivative should be accounted for using the standard hedge accounting models, and derivatives should always be measured at fair value. The 10-year swap would be designated in a fair value hedge of interest rate risk, and the 2-year swap would be designated in a cash flow hedge of interest rate risk. The Board should clarify this in the final standard to avoid unnecessary misunderstandings or lack of consistency in practice.

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 with this principle. Citigroup particularly supports that this model will permit hedge accounting for many common risk management strategies for non-financial commodity exposures. However, hedges of credit risk remain challenging (restricted) under these proposals, and we do not understand why credit risk continues to be singled out for special onerous treatment. We do not agree with the Board's assertion that measuring the credit risk component of a loan or a loan commitment is overly complex. There appears to be a conceptual difference in the model proposed to be applied to

financial instruments versus non-financial instruments. In a principles-based standard, we do not understand why such a distinction is necessary. For example, inflation is not an eligible hedged risk in financial instruments unless it is contractually specified, whereas it would presumably be an eligible hedged risk in a non-financial item.

Citigroup recommends that the final standard permit hedging of further risks in line with common risk management strategies of enterprises. For example:

- In industry group discussions, we are aware of the view that the ED would not permit hedging of the rubber cost component in the purchase of tires due to the extensive production costs and the basis differences that those costs create. However, as explicitly stated in the ED, it would be possible to hedge the crude oil component of jet fuel (due to the market indices which reflect pricing of both commodities). Given that rubber costs are clearly a component part of the cost of tires, this disparity suggests that the current proposal is overly restrictive and rules-based (i.e., we do not understand why it is not possible to hedge where there is no market structure basis for the component of the pricing designated as the hedged risk – even if there is a clear conceptual link).
- Many corporate entities look to hedge expected increases in future salary costs due to inflation. This is a real business risk, which will impact cash flows, and which an entity may want to manage. Under the current proposal, it is unclear whether such a hedging strategy would be permitted.
- Many corporate entities also look to hedge the variability which is experienced due to changes in foreign currency exchange rates when the group has revenues and expenses (net income) in subsidiaries with functional currencies different to the group's functional currency. From an accounting standpoint, these business risks are generally designated using a Net Investment Hedge which addresses only the balance sheet exposures of the subsidiary. If the foreign currency denominated cash flows were received directly by the parent, they would represent a potential hedged item. We note that the overall risk for the reporting group is not different because the flows are received by the subsidiary, and so the overall group's risk management strategy may reasonably be expected to be identical regardless of where the cash flows are received. As such, this exclusion seems inappropriate.
- Many corporate entities have a stated risk management strategy to match the basis of their funding against the basis of their assets, and as such may wish to manage risk through the use of a basis swap (floating interest rate versus floating interest rate with different reference index). For example a company may hold a floating rate bond with 6-monthly resets, but predominantly fund itself through the short-term debt markets with 3-month commercial paper. As currently drafted, differences in floating rate bases are not permissible as a hedged item.

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?

Citigroup is broadly supportive of the proposals to allow hedging of a bottom layer of an asset or group of assets. We look forward to the more detailed guidance on macro-hedging regarding portfolios of financial assets with prepayment 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?

We do not agree with the hedge effectiveness requirements proposed in the ED. In particular, we think that the requirement to consider and potentially adjust the hedge ratio each period to minimize expected hedge ineffectiveness is operationally burdensome, costly and unnecessary. Although the ED explicitly allows qualitative effectiveness testing in certain cases, we do not understand how qualitative assessment can ever be applied if the effectiveness test is based on the quantitative hedge ratio that is always expected to minimize hedge ineffectiveness.

Citigroup supports removing the 'bright line' rules for hedging ratios from the effectiveness criteria, commonly referred to as the 80-125% test. We also agree that effectiveness testing should reflect the entity's risk management activities, which may tolerate some hedge ineffectiveness. Please refer to Question 1 for further comments on the level of documentation of the entity's risk management strategies and Question 7 for comments on rebalancing.

Overall, we believe that the effectiveness requirements in the ED should be replaced with a qualitative analysis to demonstrate that the relationship provides an economic offset between the hedged item and hedging instrument. We would refer the Board to earlier proposals from the FASB, which we believe are far superior in terms of the assessment of effectiveness than the new concepts created in the ED.

Paragraph B35 in the exposure draft includes the term "magnitude," stating that "any value already reflected in a derivative at the point of designation into a hedging relationship does not mean that a qualitative test of effectiveness would not be appropriate, but that the continued appropriateness would be based upon the 'magnitude' of any ineffectiveness which this might cause". The term magnitude seems to have a very straightforward literal meaning – but is not defined in accounting terms in the standard,

and therefore provides an opportunity for diversity in practice or for the creation of another bright line to replace the 80 – 125% corridor.

Although reducing the requirements for effectiveness may reduce the work of performing hedge effectiveness testing, the measurement process proposed in the ED would often be more complex and onerous than the existing requirements in IAS 39. For example, a common strategy is to assess hedge effectiveness based on changes in spot rates or cash prices, especially in hedging situations where the timing of the underlying exposure is uncertain within a specified time period. This is consistent with the current and proposed guidance that allows entities to separate the interest element and the spot price of a forward contract and designate as the hedging instrument only the change in the spot element of a forward contract and not the interest element.

The ED would require that the time value of money be considered in measuring hedge ineffectiveness. Requiring the spot component to be calculated on a discounted basis introduces significant practical issues. In many cases, companies do not have any way to predictably forecast the timing of the payments during the specified time period and therefore have no reliable way to define the appropriate hypothetical derivative, for example, when hundreds or even thousands of cash payments are made on capital projects. There could also be considerable ineffectiveness for companies who use shorter-dated derivatives due to credit or market constraints to hedge longer-dated exposures. We believe that entities should have the ability to assess hedge effectiveness and measure hedge ineffectiveness using spot risk on a non-discounted basis consistent with an exclusion of the interest element.

The requirement to measure changes in creditworthiness for both the actual derivative and the hypothetical derivative also creates significant practical issues. For example, how would a company measure changes in credit risk associated with forecasted FX revenues from ten customers or from 10,000? It may also be impractical for a company to measure the change in creditworthiness of forecasted purchases of electricity or corn sweetener or natural gas from small and perhaps local suppliers who do not have an observable credit default swap spread or credit rating. We believe it is critical that a final standard provide more practicable approaches to measuring hedge effectiveness, in particular for changes in creditworthiness.

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 find that this proposal is not clearly expressed in the ED, and there is unclear guidance on how it might align with the risk management objectives of the reporting entity. Further, the requirement to rebalance creates a number of practical and implementation issues. Citigroup believes that this guidance should be removed from the final standard, because the potential costs far outweigh any perceived benefits to financial statement users. In particular, we question what benefit a compulsory rebalancing would add for the reporting entity in a simple hedging relationship scenario such as debt hedged for interest rate risk with matching notional amounts. For any hedge where the terms of the hedged item and hedging instrument match perfectly or very closely, a qualitative assessment without the requirement to rebalance the hedge should be sufficient despite some ineffectiveness that is expected to occur due to the differences in measurement of the hedged item and hedging instrument.

In practice, risk management strategies often must be expressed with broad parameters, for example, that an entity should maintain interest rate risk within a certain range. Should compulsory rebalancing be required, we are concerned that the accounting literature will require an entity to trade to achieve rebalancing (i.e., create an incremental cost to the entity) simply to meet the hedge accounting rules, rather than to meet an actual risk management or business requirement.

We remain extremely concerned about how these requirements will be interpreted in different jurisdictions. Overall, the requirements in the ED are not clear and run a very real risk of bright-line rulemaking or significant inconsistencies in application.

Should the Board decide to retain these requirements, we request that further implementation guidance be provided to enforce a consistent differentiation between ineffectiveness being present in the relationship, but the relationship still achieving a reasonable hedging ratio as determined in the risk management strategy, versus persistent ineffectiveness which could require rebalancing. Furthermore, since the ED currently seems to require rebalancing for every hedging relationship each period, the Board should more clearly articulate the circumstances in which a rebalancing is actually required. Questions that we believe need to be addressed include:

- Is the Board's intent that only significant and persistently high levels of ineffectiveness should trigger a rebalancing? Or would nominal ineffectiveness or other 'normal' changes in the statistical relationship between the hedged item and the hedging instrument require rebalancing? Can the Board provide explicit guidance which will allow reporting entities to determine what would constitute a nominal level of ineffectiveness?
- If a reporting entity fails to rebalance a hedging relationship, does that trigger the loss of hedge accounting and potential restatement risk? It is not clear what processes should be followed if the hedging ratio is not rebalanced in such an instance (for example by purchasing a new derivative). Would there be a requirement to rebalance for accounting purposes only? Or would the act of not rebalancing effectively lead to a de-designation event (i.e., voluntary de-designations by proxy)?

- Can a qualitative analysis ever truly be sufficient, given that rebalancing is required to reach the “optimal” hedging ratio? Should the final standard provide a specific definition of what would qualify as “optimal”?
- The examples in the ED are focused solely on *quantity*, and not on for example timing. Would a change in the estimated date of a forecasted transaction require a rebalancing event where the maturity date of the derivative must be amended?

Question 8

- (a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

We believe this is a fundamental flaw in the ED. Refer to Question 1 for further comments on why hedge accounting should be elective, both at inception and for de-designation of a hedge accounting relationship, and Question 7 on rebalancing.

There is currently no explicit requirement in the ED that hedge accounting has to comply with the risk management strategy (i.e., we may have a risk management strategy to limit interest rate risk in a fixed rate bond portfolio, but there is no requirement to apply hedge accounting to that portfolio – hedging remains an elective model at inception). We indicate again that there are many different levels of risk management throughout a complex business, and would question how one is intended to prove that the risk management objective for a particular hedging relationship has, or has not, changed – thereby requiring a de-designation. If the overall risk management objective has not changed but the entity decides to use a different hedging strategy to manage the same risk (which would meet the same risk management objective), would the entity be precluded from dedesignating the first hedge in order to enter into a replacement hedge? The ED creates significant restatement risk and potential for “second-guessing,” for little or no determinable benefit to the financial statement user.

There are also practical inconsistencies introduced by the current model. For example, if the reporting entity terminates a derivative, the hedge is automatically de-designated (but termination will likely cost money in real terms due to the application of funding charges by the counterparty); because of this cost, most reporting entities would instead seek to close out derivative positions by entering into an offsetting trade (typically at minimal or zero cost). While risk management monitoring or strategies would consider the ongoing risk profile of the entity under either scenario as almost identical, the current proposal would not treat these two instances in the same way. Hedge accounting would be required to continue in the second situation.

We also note that the majority of financial institutions are risk taking entities, and will frequently take a view on expectations of future variables. For example, entities may wish to hedge interest rate risk where it is thought likely that rates will soon be rising and the entity owns fixed rate assets; but may wish to de-designate that hedge after a period of time if interest rates are thought to have peaked. The most cost effective method of hedging may be to utilize swaps to enter into hedges, and offsetting swaps to close out hedge positions (as opposed to using more expensive risk management trades like options). We do not believe the Board intends accounting standards to create real costs to the business for little or no determinable benefit (i.e., the risk management strategy would be the same regardless of the instrument used, but the cost of hedging could be very different).

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?

While we do not object to the proposals, we do not believe that posting the results of both the derivative and the hedged item to OCI provides useful information to the user of the financial statements. Since any difference between the two OCI amounts represents ineffectiveness that must be transferred to profit or loss, the two amounts remaining in OCI will be the same and net to zero.

We are concerned that the basis adjustment which, under the ED, is required to be presented as a separate line on the balance sheet does not meet the definition of either an asset or a liability. There are also significant practical concerns about tracking which balances are recorded within such an account at a complex institution where hedge accounting is used extensively. There are currently no systems in place which could track or monitor such an account on an ongoing basis. Citigroup recommends that the final standard carry over the existing requirements in IAS 39.

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 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 (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?

Overall, Citigroup strongly supports the proposed model where changes in an option’s time value are recorded to Other Comprehensive Income. The rules under IAS 39 that require changes in an option’s time value to be recorded immediately in earnings produce counterintuitive results, do not provide useful information to the users of financial statements, and have in practice driven hedging behavior in certain circumstances.

We believe the proposals in the ED could be improved and simplified and suggest the following:

- In order to avoid additional complexity in the hedge accounting model, we recommend that the names of these strategies be kept consistent with already established terminology. That is, a transaction-related hedge is a cash flow hedge, and a period-related hedge is a fair value hedge. The creation of two new terms (and resulting models) in the ED does not provide additional benefit.
- The approach for assessing and measuring ineffectiveness should be kept consistent with all other types of hedges.
- The proposals around “aligned time value” are complex and will be difficult to implement in practice. Even the simplified examples provided by the IASB on the project website are challenging to understand. As such, we request that clear implementation guidance be prepared and included in the final standard to demonstrate how these processes should function when implemented.
- To make the model operationally practicable, we would prefer the Board to introduce some practical expedients. For example, consistent with the FASB Exposure Draft on hedge accounting, where an option which settles on the 15th of the month is transacted to hedge cash flows which are expected to occur throughout the month, the FASB would allow the reporting entity to presume perfect effectiveness. This model would result in substantially similar results without the undue complexity and additional rule-making necessary in the IASB’s ED. The further interplay with the rebalancing rules makes this an area where improvements are needed in a final standard.

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?

Citigroup agrees in principle that the Board is moving in the right direction, and look forward to the macro-hedging phase of this project to provide more details on hedging groups of items.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

We agree that it would be inappropriate to “gross up” the results of the derivative on several different lines on the income statement.

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?

The disclosures currently proposed are too voluminous and will overwhelm users of the financial statements. We recommend more tailored and focused disclosure requirements.

Disclosures of the entity’s risk management strategies for each category of risk which is subject to hedge accounting will also be determined by the level of the reporting entity at which that risk management strategy is controlled. For a global financial institution, this could result in extensive disclosure of micro-risk management strategies. See our response to Question 1 for more details.

Paragraph BC195(b) requests disclosures of information for each future period that a hedging relationship is expected to affect profit or loss. Citi has issued fixed-rate debt with maturities of greater than 30 years, and hedges that debt for interest rate risk with interest rate swaps. The ED would request disclosure for each of the next 30 or more years for our exposure to market price risk due to interest rate changes, the amount we are hedging out of that total, and how hedging changes that risk exposure. We do not think it is practicable to forecast our risk exposure for such a long period of time. Even for hedges that have much shorter maturities, forward looking quantitative data are necessarily subjective and subject to change; thus, we question the validity of including this information in the footnotes.

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 are broadly supportive of this principle, and consider it may be a useful practical expedient for some reporting entities.

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?

Citigroup believes that providing alternatives to hedge accounting through exceptions introduces significant additional complexity to the accounting for financial instruments. We do not agree with the Board's assertion that separating the credit component in the value of a loan or a loan commitment is unduly complex, and consider that credit should be an eligible hedged risk component. The final standard should provide principles-based requirements and, in our view, under those principles many economic hedges using CDS would qualify for hedge accounting.

Citigroup also believes that CDS are a form of purchased option, and the proposed guidelines around option hedging strategies could equally apply to purchased CDS. We recommend that the Board consider such an approach in more detail, as much of the conceptual work has already been completed through the proposals in the ED.

If the final standard does not permit management of credit risk in financial instruments with CDS under the hedge accounting model, we consider that these alternative proposals would be an improvement over the current IAS 39 model, regardless of the additional complexity involved. However, the model needs to be more principles-based, consistent with the risk management strategy of the reporting entity, and consistent with the hedge accounting objectives stated in the ED.

We are aware of other institutions which represent credit institutions (e.g. the International Association of Credit Portfolio Managers, or IACPM) that are very supportive of these alternatives. It is critical that credit managers be provided with appropriate accounting methodologies to represent risk management practices which are pervasive throughout the industry. As such, if the Board does not permit hedging using

CDS under the standard hedge accounting models or the guidance on option hedging, we strongly recommend considering the views of the IACPM and other bodies in this area.

To address the proposals more specifically:

- Alternative 1: In our view, Alternative 1 is overly restrictive due to the requirement to elect the fair value option only at inception. We note that the proposed hedge accounting model remains elective and hedges may start at any time after recognition of the hedged item presuming that the hedges are supported by the risk management strategies of the entity. There are also obvious practical instances where high quality credit exposures could be purchased but could deteriorate significantly after initial recognition, alongside a risk management strategy which would require the purchase of financial instruments to mitigate credit risk for such exposures only if the credit quality deteriorates.
- Alternative 2: In our view, Alternative 2 does not provide significant additional benefit over Alternative 1 even though the ability to invoke the fair value option may be taken subsequent to the date of initial recognition. Should the entity elect the fair value option after initial recognition, the life-to-date gain or loss on the instrument is forced to the income statement directly, giving much the same result as if the instrument had always been at fair value since initial recognition. This retrospective application of the fair value election is consistent with neither the overall model for hedge accounting nor the fair value option under IFRS 9. It may also yield opportunities for the reporting entity to record gains in instances whereby, for example, the value of a fixed rate loan otherwise recorded at amortized cost has increased since origination due to movements in interest rates, or could incentivize firms against properly representing their risk management strategies in the income statement where loans have suffered losses since recognition even where CDS are subsequently used to manage credit risk.
- Alternative 3: Alternative 3 is our preferred approach, although we continue to consider that it remains limited. The ability to elect the fair value option after the date of initial recognition with the life-to-date fair value movement amortized to the income statement is the most consistent with the hedge accounting model presented. Please refer to our comments above which detail different approaches that we think merit consideration and are far superior to any of the alternatives presented.

Question 16

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

Citigroup agrees that the transition requirements for hedge accounting should be prospective. As hedge accounting is an elective model, and the designations are intention based, it would be inappropriate to include any element of retrospective application.

However, any transition should be considered in light of the partial retrospective application currently proposed under the recognition and measurement phases of IFRS 9. Those phases would currently require reporting entities to present comparatives on a mixed measurement basis – i.e., the new IFRS 9 requirements would be applied for instruments still held at the opening balance sheet date with application of the previous hedge accounting rules under IAS 39; the previous IAS 39 rules for recognition and measurement would be applied to items that are no longer held at the balance sheet date. It is critical that the final standard provide comprehensive transition guidance and examples that address the interplay between each phase of IFRS 9.

We would support the proposals already mentioned by other institutions to include a date of initial adoption (DIA) in the standard that coincides with the earliest date included in the comparative numbers. This would allow meaningful balances to be presented as comparatives and would accurately reflect the business intentions and risk management strategies employed throughout the period (including those relating to hedge accounting).