

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
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Group Chief Accountant's
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Dear Sir David

ED/2010/13 Hedge Accounting

We welcome this opportunity to set out our views on the Board's hedge accounting exposure draft.

We support the Board's objectives of simplifying accounting for derivatives and hedging activities, resolving existing practice issues, and improving the reporting of financial instruments for users of financial statements. However important elements of the exposure draft are not convergent with US GAAP and would place an undue burden on financial institutions that report both IFRS and US GAAP. We urge the Board to work closely with the Financial Accounting Standards Board to develop a comprehensive joint accounting standard for derivatives and hedging.

Our responses to the questions in the invitation to comment are set out in the appendix to this letter.

Please contact me should you wish to discuss our response.

Yours sincerely



Rajan Kapoor
Group Chief Accountant

Objective of hedge accounting**Question 1**

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

We support the hedge accounting objective proposed by the Board. However we do not believe that the restriction preventing the hedging of risks that do not affect profit or loss is consistent with a risk management view of hedging; it should be removed.

We also have some concerns about how the principles in the exposure draft would apply where an entity establishes hedges meeting the exposure draft's criteria but which do not directly reflect the risk management objective (because qualifying hedges cannot be put in place that meet this objective) for example hedging customer deposits with receive fixed interest rate swaps documented as cash flow hedges of variable rate financial assets.

Instruments that qualify for designation as hedging instruments**Question 2**

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

Yes, we agree. However, we do not agree with the exclusion of written options from hedging instruments. We believe that written options should be allowed as hedging instruments provided they form part of a multiple instrument hedging position that is not overall a net written option.

Derivatives that qualify for designation as hedged items**Question 3**

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

Yes, we agree. However, we do not believe that the exposure draft is sufficiently explicit on the mechanism for recording hedge relationships involving a hedged item that is a combined exposure. We are not clear as to the mechanics of computing the gain or loss on the hedged item to be recorded as a separate line item in the statement of condition given that the derivative component will be measured at fair value through profit or loss. We would welcome some illustrative example on this issue in the application guidance.

Designation of risk components as hedged items

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

Yes, we agree. We welcome the relaxation for non-financial items; though it is unlikely to be significant for the Group. We set out our views on the hedging of credit risk in our comments on question 15.

Designation of a layer component of the nominal amount

Question 5

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

Yes, we agree. Designating a layer is an important element of some risk management strategies. However, we would suggest that the paragraphs in the application guidance are redrafted to make the distinction between 'percentage' and 'layer' components absolutely clear.

(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?*

No. We do not support this restriction. This is a very significant issue in the context of portfolio hedging; where we believe hedging a 'bottom layer' for which expected prepayment is virtually zero is entirely acceptable.

Hedge effectiveness requirements to qualify for hedge accounting

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

We welcome the removal of the 80/125% condition; the move to a qualitative assessment of effectiveness; and the elimination of retrospective effectiveness testing. However, we have some concerns about the hedge effectiveness requirements set out in the exposure draft:

- One of the conditions for hedge accounting (in paragraph 19 (c)(ii)) is that the relationship 'is expected to achieve other than accidental offsetting'. This condition is in our view otiose given the principal condition that there is documentation of the entity's risk management objective and strategy for undertaking the hedge. It seems to us inconceivable that a hedge that has a documented objective and strategy would fail the other than accidental offsetting criterion.
- We are not wholly convinced by the use of 'unbiased result' as a hedge condition. For example, where the hedging instrument is only available in

standard size eg futures we would not agree that the resulting bias should preclude hedge accounting provided the number of lots is that which results in a hedge ratio closest to optimal.

- We are concerned that the hedge effectiveness requirements as drafted (eg "unbiased result") may be interpreted in practice to require a continual effectiveness test to prove there is no "bias" which may be more burdensome than the existing 80/125% standard.

Rebalancing of a hedging relationship

Question 7

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

No. We do not believe that an accounting standard should (or indeed in practice could) force an entity to undertake a particular transaction or transactions. If a hedging relationship fails to be effective it is up to the entity to decide what remedial action if any it takes. The standard must deal with the consequences of management's decisions. In our view if a hedge is no longer effective and management decides to take no action, hedge accounting should be discontinued.

- (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?*

Yes we agree. This is sensible approach reflective of risk management practice.

Discontinuing hedge accounting

Question 8

- (a) *Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?*

No. As discussed above we believe that rebalancing should be optional and consequently that hedge accounting should be discontinued for an ineffective hedge that is not cured by rebalancing.

- (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?*

No. The crux is the level at which assessment of hedge effectiveness takes place. An individual hedge that remains effective and meets the risk management objective may, due to changes in market conditions, no longer be the most economic and effective way to hedge the exposure. The ability

to terminate hedges facilitates a key aspect of risk management: the adjustment of hedges as circumstances change or the entity's portfolio of risk exposure changes.

Accounting for fair value hedges

Question 9

- (a) *Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?*

No. We can see no persuasive argument for passing fair value hedge accounting entries across other comprehensive income; it creates complexity with no associated benefit. We support the existing IAS 39 approach.

- (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?*

No. In our view the Board's approach is the least attractive of the three available adding unnecessary noise to the statement of financial position. We would prefer fair value adjustment to be included in the balance sheet caption of the hedged item. Our next choice would be aggregating the adjustments into two balance sheet captions one for assets and one for liabilities.

- (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?*

No. We see little merit in this suggestion. We prefer inclusion within the caption of the hedged item with disclosure of the hedge gains and losses in the notes.

Accounting for the time value of options for cash flow and fair value hedges

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?*

Yes, we agree.

- (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?*

The proposal may be theoretically pure but at the cost of significant complexity. We suggest that a simpler approach is developed by the Board that transfers time value from other comprehensive income that is consistent with the treatment of the hedged item.

The description of 'aligned time value' appears to indicate that it is the time value of a hypothetical derivative. Given that this concept exists it should be used to avoid introducing what might appear to be a new concept.

- (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?*

See our response to question 10 (b).

Eligibility of a group of items as the hedged item

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

We see this issue as being inseparable from the Board's deliberations on macro hedging. In any event, we agree with EFRAG's view that 'it is not immediately evident from the ED what the underlying principle is for the treatment of groups of items. We also have concerns over the additional restriction in relation to cash flow hedges of groups of items which would appear to penalize entities that report more frequently.

Presentation (groups of hedged 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?

No. We support grossing up line items in these circumstances as this better depicts the hedge activity. There seems little point in requiring entities to enter into additional hedges merely to obtain a particular accounting presentation viz showing the effect on each hedged caption.

Disclosures

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?*

We support the overall objective for disclosure set out in paragraph 42 of the exposure draft. However, we do not support the detailed and extensive disclosures required by paragraphs 49-52. We advocate an approach that is sufficiently flexible to be applied by entities with relatively modest volume of straightforward hedge relationships and by those with large volumes of complex hedges; a long list of detailed disclosure requirements does not meet

this goal. We suggest that the Board considers disclosure requirements along the lines of those currently required by IFRS 7.

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

We agree.

Accounting for credit risk using credit derivatives

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?*

No. Although complex, the alternatives in BC 226 provide methods for accounting for hedges of credit risk that reflect how credit risk is actually managed. As such it gives insight into the purpose and effect of credit hedging by linking accounting with risk management and fulfils a key objective of the ED.

Not allowing elective fair value would perpetuate the current unsatisfactory position where the constraints around the fair value option and current hedge accounting requirements make it all but impossible to reflect the economic hedge position without volatility caused by the accounting mismatch between fair value derivative and amortised cost asset.

- (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?*

Alternative 3 most closely represents the way credit risk is actually seen and managed and gives the closest approximation to the economic substance of the hedge. The ability to elect to fair value when a hedge is put on and discontinue fair value accounting when the hedge is unwound together with the ability to hedge a component of the nominal amount gives the most accurate reflection of the actual risk position.

The amortisation of the measurement change over the life of the instrument eliminates the accounting mismatch which would otherwise arise in alternative 2 and produces the most consistent and relevant information.

Effective date and transition

Question 16

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

As set out in response to the Board's consultation on effective dates, we advocate an effective date for IFRS 9, in its entirety, of 1 January 2015. We are in favour of prospective application of the hedging phase of the standard acknowledging that this will give rise to a lack of comparability over the transition period.

