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Exposure Draft ED/2010/13: Hedge Accounting

Dear Sir David,

Deutsche Bank would like to thank the IASB for the opportunity to comment on the Exposure Draft ED/2010/13 Hedge Accounting ("the ED"). We welcome the Board's initiative to reduce the complexity in applying hedge accounting under current IAS 39.

While we broadly support the direction of the ED, specifically with respect to aligning hedge accounting with an entity's risk management, we have the following specific concerns which we urge the Board to address before finalising a new standard for hedge accounting:

- The ED proposes an alignment of hedge accounting with an entity's risk management strategy. However, it still contains restrictions that will lead to divergence between the risk management strategy and hedge accounting. As such, we are concerned about the unintended consequences that the restriction to de-designate will have by making hedge accounting operationally more difficult (or in some cases not available at all). In addition, the Board's expectation that an entity's risk management strategy is based on a very micro transaction level. This is not the case with large financial institutions where risk management is determined at a much broader macro/portfolio level. We therefore recommend that the Board re-visit this stated objective after phase 2 is completed. We outline our concerns in more detail in Questions 1 and 8 in the appendix.
- Important to note is that in the absence of the Board addressing the above items in either the re-deliberations of phase 1 or through phase 2, we question whether and how there can be an adequate link between the risk management strategy of the Bank and hedge accounting. That is, it would not be appropriate for the new hedge accounting model to premise itself on being linked to risk management if hedge accounting continues to be delinked from risks management. Therefore a linkage to risk management may need to be removed as a pre-requisite in a final hedge accounting standard.

- The Board should re-consider developing a hedge accounting solution for credit risk hedging. This represents a major issue for financial institutions under current IAS 39 rules. Although we appreciate the Boards proposal on the three alternative “Fair Value Option” extensions, we strongly believe that a robust hedge accounting approach would be more in line with the overall objective of a principles based hedge accounting framework. In our view, such a solution would appropriately reflect how a financial institution risk manages its credit risk exposure in practice. See our response to Question 15 attached.

- We are concerned that an effective date subsequent to that for IFRS 9 classification and measurement will be confusing to users, introduce complexity to preparers and give rise to a lack of comparability between reporting periods in that IFRS 9 will need to be applied retrospectively (from 1 January 2012) whilst the hedge relationships in the comparative numbers will still reflect the previous IAS 39 hedge accounting rules. Assuming that the phase 2 of hedge accounting brings about significant change, we believe that the Board should consider how to bridge the old hedging rules with the new hedging rules through transition disclosures. Before finalising the hedge accounting standard, we believe that the Board must take the above transition issue into consideration.

- We do not agree with the general prohibition of hedge accounting for items that are measured at Fair Value through OCI (FVTOCI). We understand that the basis for this restriction is that no P&L would be taken on these instruments (apart from dividends). However, we would support the hedging of foreign exchange risk ('FX'). Therefore we believe the Board should re-consider this matter.

Finally, we are pleased that macro hedging is being addressed by the Board and would like to reiterate that such a model should include appropriate but practical solutions to the long outstanding issues of considering pre-payment risk and hedging demand deposits which most financial institutions are faced with when applying hedge accounting on a macro/ portfolio level.

We therefore believe that a comprehensive assessment of the hedge accounting requirements of this ED can only be concluded when the Board has finalised its deliberations in phase 2. In this respect we ask the Board to consider a re-exposure of this ED when seeking comments on the conclusions from the second phase of the hedge accounting project.

Our responses to the questions in the ED which significantly affect our business are attached in the appendix to this letter.

We hope you find our comments useful and relevant, and look forward to continuing to work with you in the future. Should you want to discuss the contents of this letter in more detail, please do not hesitate to contact Cynthia Mustafa at the following email address cynthia.mustafa@db.com and phone number 020 754 50978.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Cynthia Mustafa', with a stylized flourish at the end.

Cynthia Mustafa
Managing Director
Global Head, Accounting Policy and Advisory Group
Deutsche Bank AG

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 broadly agree with the principles in the ED to align hedge accounting with risk management strategy, however, we do not believe that the notion of the linkage to risk management strategy is articulated clearly in the ED. Moreover in the absence of addressing the macro portfolio hedging issues, the ED does not achieve its stated objectives in regards to financial institutions. The following paragraphs further describe issues that we observe:

1. There is no definition of risk management or the level at which risk management has to be formulated/documented in the ED. However, the current wording in the ED may suggest that it is considered at a very micro transaction level (for example the ED requires that a hedge relationship is terminated when the risk management objective changes). If the premise in the ED is that a risk management strategy exists at a micro level, this is a concern since risk management in most large financial institutions is considered at a much broader/macro/portfolio level. We therefore feel that the ED is written from a corporate view – and does not consider the complexities of the financial institutions that have different business units with different risk management strategies. This leads to additional complexity for the application of hedge accounting in large financial institutions, particularly where the link to the risk management is considered in such key determinations as to whether a hedge meets the effectiveness assessment (see Question 6), whether rebalancing is required (Question 7) and whether an entity is allowed or required to de-designate (see Question 8).
2. We acknowledge that there are parts of the ED which better align hedge accounting with risk management than what exists today under IAS 39 (e.g., the ability to designate risk components for non financial instruments as per Question 2 and the ability to designate non derivatives instruments as hedging instruments for other than foreign currency risk as per Question 3). However the ED cannot fully fulfil its objective of aligning risk management with hedge accounting as there remain significant restrictions that do not allow hedge accounting where economic hedging is done (see our responses to Questions 4 and 15). Until those restrictions are addressed, it is not possible to fully align hedge accounting with the risk management practices of the entity.

In summary we are concerned about the operational aspects of demonstrating the linkage to risk management strategy; especially if that linkage must be, for accounting purposes at a detailed level for accounting purposes whereas the risk management strategy in practice is at business unit/ model level. We therefore recommend that the Board re-visit the stated objective after phase 2 is completed. Important to note is that in the absence of the Board addressing the above items in either the re-deliberations of phase 1 or through phase 2, we question whether and how there can be an adequate link between the risk management strategy of the Bank and hedge

accounting. That is, it would not be appropriate for the new hedge accounting model to premise itself on being linked to risk management and as such we would not support there being a linkage to risk management as a pre-requisite to applying hedge accounting.

Question 2

Eligibility of non-derivative financial instruments as hedge instrument: 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 support the proposal to permit designation of non-derivative financial instruments as hedge instruments.

Question 3

Designation of an aggregated exposure: Do you agree 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 support the proposal to allow designation of aggregated exposures as hedged items.

Question 4

Designation of a risk component: 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 hedge accounting should be allowed for a risk component approach provided the criteria in paragraph 18(a) are met.

We ask the Board to re-assess its current proposal to not allow hedge accounting for items that are measured at Fair Value through OCI (FVTOCI). We understand that the basis for this restriction is that no P&L would be recognised on this instrument (apart from dividends). However, we disagree with this prohibition on that basis and believe that at a minimum the foreign exchange risk ('FX') should be allowed to be hedged. This is an important issue in circumstances where the acquisition of a FVOCI instrument has been financed through foreign currency denominated funding. Therefore we request the removal of paragraph 4 in the ED which prohibits hedge accounting to FVOCI items.

Moreover, we believe that the current ED effectively favours the designation of non-financial components over financial components when considering the specific examples and comments made throughout the ED.

For instance, in relation to the designation of non-financial risk components which are not contractually specified the ED states in B15 (b) an example where “an entity based on analysis of the market structure for oil and oil products concludes that although crude oil and gas are not specified in any contractual arrangement there is a relationship between their prices and the jet fuel prices.”

The current wording indicates to us a higher flexibility in case of non-financial risk components by referring to an “underlying relationship” that is identified when generally analysing the price behaviour of jet fuel. In contrast, for financial risk components the ED makes very specific comments on why certain components are not available for designation (refer to IN46, IN22, and B18). In our view, this is especially concerning if one appreciates that the financial markets are commonly considered as the most sophisticated of any markets and therefore should be equally able to appropriately identify risk components that are not contractually specified.

We believe that it is not appropriate to make statements in the ED as to what risks are or are not “reliably measurable,” such as those regarding credit risk, prepayment risk, and inflation. We believe that such statements will inevitably lead to a more rule-based application of the standard, which we believe runs counter to the Board’s expressed objective of issuing a more principles-based standard. We note that the financial markets continue to evolve and innovate at a very rapid pace and are constantly developing new indices and instruments, such that what may be considered difficult to measure today may become a standardized metric tomorrow.

Accordingly, we believe that the Board should limit the requirements to the general principles that a risk component is separately identifiable and reliably measurable but should eliminate or amend the references to credit risk, prepayment risk, and inflation as not meeting this definition (as currently stated in IN46, IN22, and B18 of the ED). Instead, it should refer to Fair Value measurement standard and its guidance on level 3 assets. See also our response to Question 15.

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 designation of a layer of the nominal amount of an item as the hedged item.

(b) We believe a layer component that includes a prepayment option should be eligible for hedge accounting provided it can be reliably measured (based on historic experience etc), this should be addressed as part of the portfolio hedging ED currently under consideration.

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?

Overall, we welcome a relaxation overall of hedge effectiveness testing, specifically the elimination of the retrospectiveness testing requirement and the fact that the ED does not prescribe specifically an effectiveness assessment method, thereby allowing qualitative assessments. We believe that as there is recognition of 100% of ineffectiveness in the profit and loss statement anyways, the new standard should relax the ineffectiveness testing to solely the 'other than accidental offset' requirement. This requirement is reasonable and adequately addresses the understandable concern of the Board that hedge relationships which do not have economic linkage or reflect deliberate mismatches should not qualify for hedge accounting.

However the current drafting in paragraphs B29 and B30 are a concern to us as the word 'minimise hedge ineffectiveness' implies that only the best possible hedging instrument can be used.

While we expect that a majority of our hedge relationships would be expected to minimise ineffectiveness anyways, there may be instances where, say, due to cost, another hedging instrument is used. Important to note however is that the entity's risk management policies require the use of tolerances or limits in deciding the hedging instrument. Our discussions with the staff during various outreach sessions indicate that the intention was not to limit hedge relationships to those which eliminate bias, but rather are in line with the entity's risk management strategy. To better reflect the intentions of the Board, we have the following drafting suggestions in regard to B29 and B30 should it be decided that the unbiased hedge notion be maintained (text added is underlined and deleted text is ~~struck out~~):

The objective of the hedge effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and ~~minimise~~ manage expected hedge ineffectiveness. Therefore, a hedging relationship shall not reflect a deliberate mismatch between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness and which would be inconsistent with the entity's risk management strategy taking into consideration any limits or tolerance levels set by the management. This means an entity has no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item such that they would produce a biased result. However, this does not mean that a hedging relationship has to be expected to be perfectly effective in order to qualify for hedge accounting.

An entity considers the relationship between the weightings of the hedging instrument and the hedged item (the hedge ratio) when assessing whether the hedging relationship will ~~manage~~ minimise the expected ineffectiveness and not be inconsistent with its risk management strategy taking into consideration any limits or tolerance levels. For example, an entity wants to hedge a forecast purchase of 100 tonnes of a commodity of a particular grade in Location A and that commodity usually trades at about 90 per cent of the price for the exchange-traded benchmark grade of the same commodity in Location B. If the entity wants to hedge the forecast purchase of 100 tonnes with exchange-traded forward contracts then a forward contract volume to purchase 90 tonnes of the benchmark grade of the commodity in Location B would be expected to manage ~~offset best~~ the entity's exposure to changes in the cash flows for the hedged purchase. Hence, a hedge ratio of 1.11:1 would manage ~~minimise~~ expected hedge effectiveness.

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) This requirement implies that a risk management objective exists for each hedge relationship (micro level), which as discussed above in Question 1 may not be the case as the risk management will be at a macro level. As drafted we believe it will be difficult to operationally implement this requirement. As stated in Question 1 we believe it is necessary to articulate the level at which risk management the ED means.

(b) Yes, in practice we always try to minimize hedge ineffectiveness so we do not see this as a significant change. As stated in our response in (a) above we are concerned about the operational issues regarding rebalancing, and the fact that it appear to be very complex when one goes through a practical example. We therefore recommend an example is considered as well as potential ways of simplification of the proposed accounting entries.

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 strongly disagree with this proposal even if we understand that the Board believes that a voluntary de-designation is not necessary anymore. Because of the restrictions on an entity's ability to hedge the net position using internal derivatives, large financial institutions are forced to regularly de-designate and re-designation process to align hedge accounting with their risk management. After discussions with the IASB staff we understand that the ED provides alternatives (e.g. hedges of net position) to this problem in that an entity could, at the inset of the hedge relationship, state that they are hedging their net position (as represented by designating the gross positions) and then de-designate the relationship in the next period as the risk management strategy can be said to have changed once the net position changed in the next period.

We would therefore ask the Board to provide more guidance or even specific examples on the application of hedges of a net position in B70 for financial institutions in this respect.

However, until the guidance in B70 is not clarified or the macro portfolio hedging issue is addressed by phase 2 of the hedge accounting project, we do not support elimination of the ability to voluntary de-designate hedge relationships. We believe that the restriction to de-designate may lead to unintended consequences and will make hedge accounting operationally more difficult and, in some cases, not available at all.

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 would it be presented?

(a) Yes, we believe this is more consistent, as this makes it similar with the cash-flow hedge accounting, but operationally more complex compared to the IAS 39 rules, as would require more manual intervention to post ineffective portion into P&L. We have stated in the past that the issue of what OCI represents needs to be debated and analysed by the Board. This proposal will effectively, to our understanding, put more into OCI (although the net impact on OCI is nil).

(b) We disagree with this proposal as it would clutter the face of the balance sheet. We are also not entirely convinced about the benefit that the changes make to financial reporting. We rather favour a single item to reflect the basis adjustments. We believe a better solution would be to present the relationship with the hedged items in the notes to the financial statements and not on the face of the balance sheet.

(c) We agree that linked presentation should not be allowed and that the Board would need to finalise their discussions of a general linked presentation concept for IFRS before any such concept is included in certain accounting standards.

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 criteria for the eligibility of groups of items as a hedged item. We believe that it appropriately reflects the way an entity may choose to manage its risk by capitalizing on the natural hedges provided by offsetting risk positions. However, as the criteria in the current ED only relate to closed portfolios we urge the Board to continue consideration of open portfolios and macro hedge accounting. In this context we would like the Board to re-confirm the current guidance of IAS 39 in regards of macro cash flow hedge accounting (IGCs F6.2 and F6.3).

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 statement of comprehensive income (e.g. 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 do not agree with the proposal. We rather believe a net presentation (e.g., in one line item in the profit and loss statement) better reflects the objective and risk management strategy behind hedging accounting for a group of items, especially when a net position is hedged.

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) In practice the risk management of large financial institutions is dynamic and changes throughout the year, reflecting the constantly changing composition of the exposures that it manages. However, paragraph 40 of the ED require the disclosure of the entity's exposure to risks that it hedges and the effect of hedge accounting on the exposures as at the balance sheet date. We believe that these disclosures provide limited value to users given that they are only a snapshot of the hedged exposures as at a certain point time. We are not aware that users of our financial statements have issue with the existing disclosure framework and as such do not see the value in these disclosures. Moreover the disclosures would be, from a practical perspective, very onerous for preparers to collect.

As discussed in the questions above, because of certain prohibitions that the current hedge accounting rules impose on the hedge accounting applied by an entity for accounting purposes (for example as previously stated the prohibition of designating LIBOR as a risk component in sub-LIBOR instruments, inability to hedge demand deposits and the inability to apply hedge accounting for credit risk), there will be a misalignment between an entity's risk management and hedge accounting. As such, the disclosures as drafted may even be misleading for users as they would imply a one to one alignment between risk management and hedge accounting.

In summary we question whether, based on a cost benefit analysis, are justified and therefore ask the Board to remove these requirements.

(b) We understand the necessity for some level of comparability – but this should not be the overriding principle as each entity's hedge strategy most likely differs. Rather we believe that users are best served by being provided narrative, qualitative and quantitative information where it compliments and provides meaningful information about an entity's hedge strategy. In terms of quantitative disclosures, we recommend that an analysis of those requirements which are already

in IFRS 7 and those required for hedge accounting in this standard be performed so as to avoid duplicative of disclosure of risks.

Question 15

a) Do you agree that an accounting treatment (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? Why or why not?

(b) If not, which of the three alternatives considered by the Board in paragraphs BC220–BC247 should the Board develop further and what changes to that alternative would you recommend and why?

(a) Yes, we agree that the 3 alternatives add unnecessary complexity and we would rather prefer that the Board amend the hedge accounting guidance to facilitate credit risk hedge accounting. We believe that this solves the issue better and would be more in line with the overall objective of introducing a robust, principles-based hedge accounting framework. We believe that such an amendment has the advantage of providing a better linkage to actual risk management practices, as well as mitigating credit risk exposure by transacting derivatives that would be considered a hedging activity under the ED.

Credit risk is the dominant risk in banks and most financial institutions. As liquidity in credit markets continues to develop, the avenues to hedge credit risk via market based instruments will broaden. We believe that further hedge accounting guidance is needed to address this important issue. Moreover, since banks and most financial institutions devote significant effort to manage credit risk, further guidance on hedge accounting to include credit risk hedges will be in accordance with the spirit of the ED, which aims to link risk management practice to hedge accounting.

In our view, the amendment may take the form in an exception to the “highly probable” condition and/ or by relaxing the “separately identifiable and reliably measurable” criteria. For instances, where an entity is hedging credit risk in line with its risk management strategy, an entity should be allowed to calculate and disclose the change in the hedged items’ fair value relating to credit risk consistent with the guidance in IFRS 7.10 and 11. We believe that this solution better reflects the nature of credit risk hedging using credit derivatives.

(b) As outlined in the preceding paragraphs we prefer the Board to consider our recommendations to facilitate credit risk hedge accounting. However, if the Board pushes forward with the three alternatives, we would consider alternative three as the one which most closely aligns hedge accounting with the dynamic approach to which the credit risk is managed in many of these financial institutions.

Question 16

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

We understand that the standard is effective prospectively from 1 January 2013 (subject to the ongoing discussions regarding effective dates of the new standards). Said differently, the ED proposes a transition date of 1 January 2013. We also understand there is currently an early adoption option provided that the entity has adopted the other parts of IFRS 9.

We are concerned that an effective date subsequent to that for IFRS 9 classification and measurement will be confusing to users, introduce complexity to preparers and give rise to a lack of comparability between reporting periods in that IFRS 9 will need to be applied retrospectively (from 1 January 2012) whilst the hedge relationships in the comparative numbers will still reflect the previous IAS 39 hedge accounting rules. The magnitude of the issues will be dependent on the outcome of phase 2 of hedge accounting (e.g., the more significant the changes to the hedge accounting rules for open portfolios as a result of phase 2, the larger the issues become).

Assuming that the phase 2 of hedge accounting brings about significant change, we believe that the Board should consider how to bridge the old hedging rules with the new hedging rules through transition disclosures.

Before finalising the hedge accounting standard, we believe that the Board must take the above transition issue into consideration.