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Director, Regulatory Affairs



March 9, 2011

Sir David Tweedie
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Ms. Leslie Seidman
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Financial Accounting Standards Board
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Re: ED/2010/13 Hedge Accounting
Invitation to Comment, Selected Issues about Hedge Accounting (File ref: 2011-175)

Dear Sir David, Ms. Seidman:

The Institute of International Finance (IIF) Senior Accounting Group appreciates the opportunity to comment on the important topic of hedge accounting. Risk management is an essential function for financial institutions and the ability to sufficiently communicate such activities to users of financial statements is of utmost importance. We welcome and are supportive of the boards' work to address this complex and currently restrictive and rules-based area of accounting.

Overall views

In our view, the proposals improve several areas of hedge accounting. We support the ED's objective to align hedge accounting more closely with risk management and to provide more useful information on hedge accounting to users of financial statements. We believe that such a principle should be faithfully adhered to throughout the ED. Hence, we believe that any rules-based scope outs should be avoided and any effectiveness criteria should be rationalized to the risk management strategies and reflect risk management tolerances. Consequently, we welcome the removal of the arbitrary 80-125% effectiveness threshold. However, we do not believe rebalancing should be mandated by accounting if it is inconsistent with actual risk management strategies.

We also support the proposals to allow for a wider range of eligible hedged items including aggregated exposures that are a combination of another exposure and a derivative, risk components that are separately identifiable and reliably measurable, and layers of

nominal amounts. We believe the ability to designate these items as hedged items is needed to meet the ED's stated objective of aligning risk management and hedge accounting.

Although we support several aspects of the ED, we do not support the IASB's intention to finalise a standard on general hedge accounting in the first half of 2011. In our view, the proposals would benefit from further consideration by the boards jointly, which implies the need of an aligned schedule between the IASB and the FASB on this topic.

Moreover, while we understand that the ED is intended to primarily address hedging accounting issues faced by corporates, we believe long-standing hedge accounting issues faced by financial institutions (mainly macro hedge accounting) deserve equal attention and that such attention is necessary for a coherent, principles-based outcome. Our main concerns regarding the IASB's ED include:

- the proposals' implications on convergence;
- the proposals' inter-relationship with macro hedge accounting;
- inconsistencies between the ED's objective i.e. to reflect the effect of risk management strategies) and rules-based restrictions related to common risk management practices within financial institutions; and
- the operationality of the proposals.

The remainder of the letter sets out our initial concerns in further detail.

Convergence

The IIF has supported convergence for many years. It remains fundamental in the view of the Institute that a single set of high-quality international accounting standards is critical in today's global financial markets. Given that risk management is practiced internationally, a single set of accounting standards that portray risk management activities would greatly benefit users of financial statements across geographical regions. Hedge accounting allows for an exception to the recognition and measurement requirements for assets and liabilities. Given the impact of its application, diverged standards in this area would impair the comparability of financial statements. In addition, many of the IIF's Member financial institutions have global risk management strategies but operate in jurisdictions that require reporting under both IFRS and US GAAP. It would be extremely complex and burdensome, if not impossible, to modify those strategies and meet divergent standards.

We understand that convergence on hedge accounting is to some degree dependent on convergence on classification and measurement. However, we note that the FASB has made some recent progress in that area and the FASB's recent decisions bring its tentative approach closer to IFRS 9. We believe the boards should first aim to achieve convergence on classification and measurement. Convergence on hedge accounting is likely facilitated by a converged approach to classification and measurement.

The FASB's standard on Derivatives and Hedging Activities has long been regarded as complex and rules-based requiring deeply specialized technical accounting resources to

ensure compliance. Yet, there have been hundreds of restatements since the requirements became effective in 1999.

We believe the ED's more principles-based approach and comprehensive re-write of hedge accounting provides a good starting point for changes to US GAAP. However, as discussed further below, we believe the IASB's ED is only a point of departure as there remain several areas where further consideration by both boards is necessary. We urge the boards to jointly consider these issues to reach a common standard. We further note that macro hedging is not addressed under current US GAAP and encourage the FASB adopt a common standard in this area.

Along with the FASB's DP "Selected Issues about Hedge Accounting" that seeks additional comments on the IASB's ED by April 25, we encourage the boards to meet together to redeliberate and agree on a converged standard once the two comment periods have ended.

Macro hedge accounting

We are deeply concerned that the ED on general hedge accounting may set an undesirable precedent when the boards subsequently address macro hedge accounting. We note that the IASB decided not to address open portfolios in its ED but considered hedge accounting in the context of groups of items that constitute gross or net positions in closed portfolios. Given that the treatment of open portfolios might be inferred from the approach on closed portfolios, it is unclear from the ED whether macro hedge accounting will be considered completely independently of the general hedge accounting model. We generally believe that under a principles-based approach, the accounting for both closed and open portfolios should be derived from a single set of principles. Hence, since the ED establishes principles for hedge accounting, it must necessarily draw from and integrate issues that are being addressed in the macro project.

The objective of hedge accounting: The ED states that the objective of hedge accounting is "to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss." Current portfolio hedge accounting restrictions set out in IAS 39 have led financial institutions to apply hedge accounting practices, for even simple portfolio hedges, that are not reflective of the actual risk management practices that are being undertaken. Methods that only artificially reflect risk management strategies through proxy designations are applied as a result of current restrictions. The requirement now explicitly linking risk management with accounting may be problematic in some situations, as many institutions often do hedge risk at the transaction level as envisaged in the ED. This would lead to perfectly reasonable hedging strategies failing hedge accounting criteria, which seems inconsistent with the objective.

Discontinuation: The ED eliminates voluntary dedesignation and allows for discontinuation of hedge accounting only when it no longer reflects the risk management strategy. It notes that it is inappropriate to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis which it qualified and continues to meet qualifying criteria (after taking into account any rebalancing).

Our experience is that many portfolio hedge accounting solutions today require periodic dedesignation of the previous closed portfolio of items and redesignation of a revised closed portfolio of items in order to make hedge accounting operational. Prohibiting dedesignation could invalidate current portfolio hedges and create significant operational barriers to applying hedge accounting.

Moreover, we note that risk management activities are dynamic. Some flexibility in designating and dedesignating hedging relationships is needed to adequately reflect underlying risk management activities. Some Members further note that the boards' concerns over abusive earnings management may be unfounded. Dedesignation mechanics leave no opportunity to manufacture earnings.

Rebalancing: The ED proposes that when a hedging relationship no longer meets the objective of the hedge effectiveness assessment but the risk management objective for the designated hedging relationship remains the same, an entity should rebalance the hedging relationship so that it meets the objective of the hedge effectiveness assessment again – even if it is not the risk management practice to rebalance. Rebalancing is a new concept and in our view further guidance needs to be developed before it is possible to determine its full implications, notably with respect to its interaction with discontinuation and its operability in practice. We are concerned that mandatory rebalancing may have unintended consequences for portfolio hedge accounting.

Prepayment options: The ED proposes that a layer component of a contract that includes a prepayment option is not eligible as a hedged item if the option's fair value is affected by changes in the hedged risk. We do not support prohibiting the layer approach for instruments with prepayment options. Financial institutions often manage interest rate risk of large portfolios of prepayable loans. We are concerned that a bright-line restriction on instruments with prepayment options (in closed portfolios) will have unfortunate implications for the development of macro hedge accounting, and in any case, such prohibition is unnecessary even in the present context.

We note that the IASB started considering a bottom layer approach for prepayable instruments in the context of macro hedge accounting. We are supportive of those efforts. In our view, such an approach would bring hedge accounting closer to portfolio management of interest rate risk.

Demand deposits: The ED does not address the issue of hedge accounting for demand deposits on a portfolio basis. This appears to carry forward restrictions that are inconsistent with the proposed objective of hedge accounting. We note that this issue relates to the remaining EU carve-out of IAS 39. We urge the IASB to consider the issue in full when developing a macro hedge accounting approach.

Given the importance of macro hedging and the possible implications and knock-on effects noted above, we do not believe the IASB should finalise a standard on the general hedge accounting model before proposals on macro hedge accounting are available and constituents are able to consider all changes to hedge accounting in full.

Inconsistencies between the ED's objective and rules-based restrictions related to common risk management practices

Despite the intent to present a comprehensive and principles-based review of hedge accounting, there are several significant issues (in addition to macro hedge accounting as noted above) that have not been fully addressed in the ED. As mentioned we applaud the fact that the ED improves IAS 39 and addresses several long-standing practice issues. However, we disagree with some of the ED's rule-based restrictions that are of particular relevance to common risk management practices of financial institutions. We do not believe that the IASB should insert its own assumptions about complex measurement issues in a standard that results in arbitrary rules. The markets and models used to value risk are constantly evolving and being refined.

It is unclear whether the ED aims to scope in all risk management activities relating to financial instruments or only particular risk management activities. The ED appears to expand the scope for application of hedge accounting (most notably for components of non-financial items), but at the same time retains and imposes new arbitrary rules. One criticism of current IAS 39 hedge accounting requirements is that the restrictive, rules-based nature of the accounting requirements often drives risk management activities and precludes the application of hedge accounting to real economic hedges. We are concerned that the ED does not fully address this criticism. We believe that rules-based restrictions are inconsistent with the ED's overall objective to align risk management and hedge accounting.

Hedging credit risk: The ED discusses possible alternative accounting treatments to account for hedges of credit risk using credit derivatives. However, the IASB decided not to address hedges of credit risk using credit derivatives because of complexities involved. We note that many financial institutions manage credit risk through the use of credit derivatives. As a matter of fact, many regulators encourage such credit risk management activities. A comprehensive review of hedge accounting should address this important issue at the intersection of accounting and risk management. In addition, an expected-loss approach to impairment recognizes that financial institutions do manage credit risk and are able to assess credit risks. It would appear contradictory to limit hedge accounting for credit risk. We believe that an approach to hedging credit risk as a risk component should be further developed. Moreover, given the recent changes to the IASB's and the FASB's proposals on impairment, we would encourage the IASB to consider any possible knock-on effects between these phases.

Some Members note that on many occasions buying a single name CDS and paying a premium is equivalent to buying insurance on the specific credit risk arising from a long cash exposure, over the maturity of the CDS. These Members believe there is some rationale to account for this strategy by spreading the premium's cost over the protection period. From a risk management perspective, changes in the fair value of the derivative during the period are irrelevant, as long as the issuer is solvent. On maturity, assuming no default during the protection period, the fair value will be nil. In the interval fair value changes could, similar to the treatment of intrinsic value of purchased options, be recorded in OCI.

Hedging inflation risk: The ED proposals prohibit designation of inflation risk as a risk component unless it is contractually specified. We note that there are developed markets for

inflation-linked cash and derivative products and that inflation risk is managed by some entities. Therefore, the prohibition on inflation risk should be reconsidered, particularly given the ED allows for hedging of non-contractual components that are separately identifiable and reliably measurement. At a minimum, it should be noted that hedged items and hedging instruments tied to measured indices (e.g. CPI) should be allowed.

Hedging of sub-LIBOR benchmark interest rate. The ED retains restrictions on designating a risk component that exceeds the total cash flows of the hedged item. We note that designating the benchmark component as a hedged item is a risk management practice that is often adopted by financial institutions when applying both micro and macro hedging. In particular, certain types of deposits that are designated as hedged items are often benchmarked at a LIBOR minus spread. Banking supervisors may also require financial institutions to invest in sovereign debt that will have a yield below LIBOR. Financial institutions often have access to other forms of sub-LIBOR funding. We believe that it should be possible to hedge the LIBOR risk as a benchmark component and treat the spread as a negative residual component. The designation of a risk component with cash flows that exceed the actual cash flows of the hedged item reflects risk management in situations where the hedged item has a negative spread to the benchmark rate.

Prepayment options: As mentioned in our comments on implications to macro hedge accounting, we do not support a restriction that precludes designation as a hedged item a layer component of a contract that includes a prepayment option. We believe this restriction is inconsistent with the ED's objective and does not permit consideration of prudent risk management strategies to hedge financial instruments that contain prepayment options.

On the whole, while the ED appears to expand the scope of hedge accounting in order to allow for better reflection of risk management activities in the financial statements, the ED at the same time retains several arbitrary restrictions for commonly hedged risks. We believe as long as the risk meets the stated principles of being separately identifiable and reliably measured, there should be no rules-based restriction to hedging that risk given the ED's objective is to allow for an entity to align risk management and hedge accounting and to present the effects of risk management activities in the financial statements. Artificially excluding certain risks and risk management activities from being eligible for hedge accounting is inconsistent with the ED's objective and distorts the financial statements.

Other areas: We note that within the basis for conclusions of the ED the IASB notes that there are some areas that the proposals do not address owing to complexity, e.g. disaggregation of hedging instruments and hedging items measured at fair value through other comprehensive income (OCI). We would encourage the IASB to further consider these issues as part of a more comprehensive joint ED. On hedging of equity investments measured at fair value through OCI, some Members note that from a risk management perspective, nothing precludes an entity from hedging such investments. As such, an accounting restriction appears again to be in conflict with the objective of the ED.

Interactions with other areas of financial reporting: We note that the ED proposes changes in presentation, viz. for example remeasurement of the hedged item is presented separately for fair value hedge accounting, hedging instrument gains or losses are presented in a separate line from those affected by the hedged items in a net position hedge. The ED also

touches on many areas of OCI usage e.g. restriction of hedge accounting to risks that only affect profit or loss, recycling of the cumulative change of an option's time value in some situations, restriction from hedging items measured at fair value through OCI. In addition, the ED proposes a large volume of new disclosures. We urge the IASB to fully consider the interaction between hedge accounting and these other areas of financial reporting particularly given the boards' joint project on financial statement presentation, joint concepts project on presentation and disclosures and on-going discussions on the use of OCI and recycling.

Operationality and complexity

We are generally concerned about the operationality of the ED proposals. The explicit link to risk management activities and accounting could be very difficult to operationalise in practice especially if the ED's intent is that the designated strategy must be the lowest denominator within the entity's risk management framework. We further note that risk management and accounting are distinct functions. Some Members would suggest that it may be more operational to for the ED to clarify that the objective of hedge accounting is to best reflect risk management activities at an "appropriate level".

We are particularly concerned about the operationality of rebalancing. In our view, rebalancing should be allowed but not required. Some Members would support rebalancing when a hedging relationship no longer meets the objective of the hedge effectiveness assessment but the risk management objective for the designated hedging relationship remains the same. However, these Members would not support mandating rebalancing at the current stage given possible unintended consequences for portfolio hedge accounting and the lack of clarity on how the approach would be applied in practice. We note the multiple decisions an entity might need to assess in determining whether or not rebalancing is needed. We believe the approach would result in further complexity as mathematical recalculations of ineffectiveness in each period and mathematical recalculations to prove rebalancing is unbiased will be needed. We would strongly urge the IASB to reconsider the operationality and implications of this approach.

We believe that mandatory rebalancing could impose tighter restrictions than today's rules e.g. 80-125% effectiveness threshold. We believe there is no basis for requiring rebalancing when risk management does not call for rebalancing. Mandating rebalancing purely to satisfy an accounting rule contradicts the overall objective of linking risk management activities with accounting.

We also note that the ED proposes that a hedging relationship must meet hedge effectiveness requirements to qualify for hedge accounting. These include that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness and that the hedging relationship is expected to achieve other than accidental offsetting. We are concerned about the operationality of these requirements. The requirements appear vague and could be interpreted as being unduly restrictive. We believe that effectiveness qualification requirements should be linked to the tolerances actually used in management's risk controls and limits. Such an approach would better align risk management activities and hedge accounting.

On the subject of effectiveness requirements, some Members would support the FASB's proposed "reasonably effective" criteria. Some Members believe that as long as ineffectiveness is reported in profit or loss and the hedge is reasonably effective, there is no further need to prove it is unbiased and minimizes ineffectiveness. The purpose of hedge accounting is not to drive risk management, but to reflect it.

Although we are supportive of the elimination of the 80-125% effectiveness bright-line, we strongly believe it is important to replace effectiveness requirements with an approach that is operational and understandable.

We note that the initial objective of the IASB's financial instruments project was to reduce complexity in accounting for financial instruments. Hedge accounting has long been a complex area of financial reporting. We are concerned that the ED replaces one set of complexities with another set of complexities in some areas e.g. effectiveness requirements for eligibility, rebalancing, and different hedge accounting mechanics and options.

In addition, we believe the proposals may not benefit users to the extent anticipated by the IASB. We are concerned that users might need to learn hedge accounting requirements that are equally complex with existing ones in order to understand the proposed presentation and disclosure changes. Moreover, in practice, the risk management of large financial institutions is dynamic and changes throughout the year, reflecting the constantly changing composition of the exposures managed. We note the ED requires the disclosure of an entity's exposure to risks that it hedges and the effect of hedge accounting on the exposures as at the balance sheet date only. We further note that the ED imposes, contrary to its overall objective, specific scope outs to hedge accounting (as noted in the previous section). Consequently, there will be an inevitable misalignment between risk management activities and risk management activities reflected in the financial statements. As such, the proposed disclosures may even be misleading and counter-intuitive for users as they would imply complete alignment. From a preparer's perspective, we believe that some of the ED's disclosures may require overly invasive and forward looking information that would be challenging to provide.

The IIF Senior Accounting Group appreciates the opportunity to comment on this important topic. Should you have any questions about this letter or the views expressed, please contact the undersigned (dschraa@iif.com; +1 202 857 3312) or Carol Wong (cwong@iif.com +1 202 857 3633).

Very truly yours,

A handwritten signature in black ink, appearing to read "David Schraa", with a long horizontal flourish extending to the right.