

March 15, 2011

IASB
30 Cannon Street
London, EC4M 6XH
United Kingdom

Dear Sir/Madam:

Exposure Draft: Hedge Accounting (ED/2010/13)

The World Bank appreciates the opportunity to comment on the IASB's exposure draft, *Hedge Accounting* ('ED'). We recognize the IASB's intent in responding to criticism from users and preparers of financial statements that hedge accounting is complex and not reflective of an entity's risk management.

We believe the criticisms reflect how hedge accounting under IAS 39 affected business. In fact, several of the shortcomings that this ED seeks to overcome are reasons the World Bank elected not to apply hedge accounting more than a decade ago. Two examples are:

- **Hedged Items:** IAS 39 (and its US GAAP equivalent) prohibits derivatives from being part of a hedged item. This ED, through paragraph 15 (and B9), allows "*an aggregated exposure that is a combination of an exposure and a derivative*" to be designated as a hedged item. Without this provision, the World Bank would not readily be able to benefit from hedge accounting for its funding issuances and related liquidity-management derivatives.
- **Designation of a Component of a Nominal Amount (Layer):** IAS 39 does not allow the designation of layers for fair value hedges (only for cash flow hedges). The World Bank's risk management policy prior to 2008 was to hedge the interest rate risk on a "layer" of its fixed-rate loan portfolio to manage the duration of shareholder's equity. Paragraph 36 of this ED (particularly the elimination of the need for individual items to move proportionately with the group), would potentially enable the World Bank to reflect its risk management approach for this area through hedge-accounting.

Notwithstanding the proposed improvements, we believe hedge accounting is inappropriate in many cases and will remain so even with the changes proposed through this ED. Our key reasons follow:

Risk management: We understand the IASB's desire to frame hedge accounting around a clear objective of representing an entity's risk management activities. Hedge accounting is however only relevant when there is mixed-attribute measurement. If GAAP minimized mixed- attribute measurement, hedge accounting would become irrelevant. Financial reporting should, in our view, provide measurement that is as far as practicable, objective and consistent. Aligning accounting (hedge accounting) to risk management is premised on the assumption that risks are being appropriately managed, and to the extent that they are not, any ineffectiveness will be surfaced through the profit and loss. We believe the financial crises have demonstrated that risks are not in fact being appropriately managed in all cases, particularly with regard to financial institutions and complex financial instruments, and so aligning hedge accounting with risk management activities may prove to be ineffective.

Comparability: Hedge accounting results in a lack of comparability between entities because of choice in hedging designations. The ED' desire of representing an entity's risk management activities through hedge accounting continues to compromise comparability. Two entities' with identical instruments but different risk management policies will report different results. Moreover, two entities with identical financial instruments and similar risk management policies may also report different results when, for example, there is a need to re-balance the hedge and an effectiveness assessment is performed between two reporting dates (B32). Essentially, by aligning hedge accounting to an individual entity's risk management, each entity potentially has its own "accounting model".

Rebalancing: While the ED's proposal of rebalancing (paragraph 23) makes better sense than the existing IAS 39 approach of de-designating the existing relationship and re-designating a new relationship, re-balancing is subjective and entity-specific. Risk management may choose not to re-balance particularly in times of perceived temporary distress for cost reasons that may result in bias (as defined through B29) for hedge-accounting purposes. However, for hedge- accounting purposes the accounting relationships would need to be re-assessed (e.g., modification in hedge ratio) to eliminate the bias. Thus, we believe that effectively risk management and accounting will not be consistent and the ED's hedge accounting objective will not be met.

Hedge Ratios: Hedge ratios implicitly assume correlation. Correlation is unstable particularly in times of distress. At such times, re-balancing by re-designating hedge ratio's to achieve "an unbiased result" may be undesirable. Additionally the ED envisages assessing hedge effectiveness on a prospective basis (B32). It may be useful for the ED to clarify whether this is meant to be done through implied correlations, where available. Using historical correlations would presumably not constitute a prospective assessment.

Operational risk: Although the ED goes somewhat in reducing the operational risk of hedge accounting by for example, eliminating the "bright-line" tests, the operational risk and cost of hedge accounting (e.g., systems, hypothetical derivatives) remains high relative to the likelihood of securing decision-useful information.

Income Management: We believe that hedge accounting based on an entity's risk management will potentially result in income management. Our concern is that risk

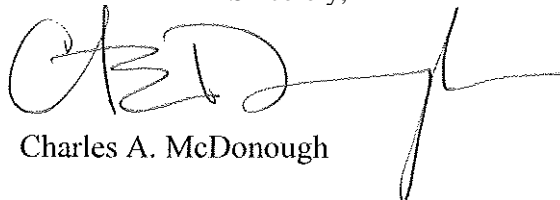
management would be defined specifically to achieve desired hedge accounting goals which may change from time-to-time based on market conditions and perceptions. In our view if hedge accounting operates as intended, and ineffectiveness is correctly reflected in the profit and loss, the results could be consistent with fair-value. Fair-value however, provides a more complete and objective picture with higher volatility reflective of open-economies. This enables entities to better appreciate their capital needs.

We regard fair value as the best (but not the only relevant) measure for financial instruments. To this end, the World Bank has since June 2001 disclosed fair value results (by reporting all financial instruments at fair value) through our Management Discussion and Analysis ("MD&A"). For the avoidance of doubt, hedge accounting may in our view be adequate for relatively elementary hedging relationships where the cost-benefit of fair value does not work-out. However, for financial institutions with complex strategies (e.g., which for example rely on internal derivatives) hedge accounting would in our view remain inferior to full fair value measurement.

Separately, we note that the Financial Accounting Standards Board (FASB) has issued a discussion paper on *Selected Issues about Hedge Accounting*. We would like to highlight that the IASB and FASB discussion papers do not address existing differences between the two boards, but rather contribute to a greater divergence in this area. We recommend that both parties commit to a joint convergence effort in this area. Finally, we would like to reiterate our concern regarding the lack of a well defined principle of what should or should not be included in other comprehensive income.

We appreciate the opportunity to provide you with our views. Please do not hesitate to contact us if you have questions or require clarification.

Sincerely,

A handwritten signature in black ink, appearing to read 'C. McDonough', followed by a long horizontal flourish.

Charles A. McDonough