

IASB Exposure Draft ED/2010/13 Hedge Accounting

Positions of the German Insurance Association

**Gesamtverband der Deutschen
Versicherungswirtschaft e. V.**

German Insurance Association

Wilhelmstraße 43 / 43 G, D-10117 Berlin
Phone: +49 30 2020-5000
Fax: +49 30 2020-6000

60, avenue de Cortenbergh
B - 1000 Brüssel
Phone: +32 2 28247-30
Fax: +32 2 28247-39

Contact:
Dr. Axel Wehling
Phone: +49 30 2020-5400
Fax: +49 30 2020-6400
E-Mail: a.wehling@gdv.de

Hans-Juergen Saeglitz
Phone: +49 30 2020-5430
Fax: +49 30 2020-6430
E-Mail: h.saeglitz@gdv.de

Executive Summary:

The German Insurance Association appreciates the opportunity to comment on the Board's Exposure Draft ED/2010/13 "Hedge Accounting" (hereinafter referred to as ED). These comments are drafted on behalf of 468 insurance companies located in and outside Germany represented by the German Insurance Association.

The replacing of IAS 39 is split into a number of phases. However, considerable interdependencies exist among the different phases of this project and other projects that the IASB is currently working on. Of special interest for the insurance industry is the balance between the insurance project and the new IFRS 9, in particular the classification and measurement phase and the macro hedging. Therefore we will not be able to comment on these proposals in full until we gain a better understanding of the Board's direction in respect of macro hedging. And we are convinced that the IASB will need to consider the entire package of proposals as a whole before finalising the resulting standards.

The German Insurance Industry fully appreciates the Board's ambitious efforts in order to reduce complexity in hedge accounting and to bring it more in line with risk management activities. Furthermore we support the Board's aim to develop a more principle-based approach for hedge accounting. The ED is a significant step in developing a new standard for the reporting of financial instruments.

Although we welcome most of the proposals in the ED, we do have some objections:

- The link between hedge accounting and risk management activities is a good starting point for the improvement of hedge accounting. However, we believe that the objective needs to consider that risk management and hedge accounting can never be fully aligned (see Question 1).
- We do not agree that eligible hedging instruments are limited to a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss. The possibility to designate equity instruments under the OCI-option as hedging items should be added (see Question 2).
- We do not believe that linked presentation is an appropriate way to deliver useful information (see Question 9 and 12).
- We believe that the proposed disclosure requirements will lead into an information overload in particular for entities who publish a separate risk report (see Question 13).

While analysing the ED we sometimes got the impression that the Board developed the proposals more to avoid abuse than to find an appropriate solution for accounting problems. We believe that an accounting standard should first of all focus on beneficial solutions for the accounting practice. A possible abuse must be prevented by solid and enforced corporate governance rules.

Questions raised by the Board

Question 1 - Objective of hedge accounting (paragraphs 1 and BC11–BC16)

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 Boards general decision to develop a more principle-based approach for hedge accounting by naming an objective for the standard. The link between hedge accounting and risk management activities is a good starting point for this approach. However, we do not fully support the proposed objective. It is eligible that financial statements represent the extent and effects of risk management activities, but we believe that this could only be a subordinated principle to be followed whenever it is possible. From our point of view risk management and hedge accounting can never be fully aligned, because of different objectives, methodologies and techniques. This differences become especially apparent in the fields of flexibility (see our answer to question 2), documentation and granularity (see our answer to question 11).

The proposed objective is not fully achievable by applying hedge accounting, because even with the new proposals certain risk management activities cannot be reflected in financial statements. This requires either a modified objective or a better alignment of essential elements of the hedge accounting requirements with the proposed objective.

Question 2 - Instruments that qualify for designation as hedging instruments (paragraphs 5–7 and BC28–BC47)

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 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, but we do not agree that eligible hedging instruments are limited to these two categories. From our point of view there is no conceptual basis for excluding any non-derivative financial instruments that are not at fair value through profit or loss.

Under the current IFRS 9 there is the possibility to present the subsequent changes in the fair value of the investment in an equity instruments in other comprehensive income. The entity has to make an irrevocable election on this at initial recognition. For us there is no comprehensible reason why these assets should not be part of a hedging relationship. In practice a hedging relationship is often arranged a time after the initial recognition. Therefore there should be the possibility to designate equity instruments under the OCI-option as hedging items. Otherwise the OCI-option under IFRS 9 is a dead-end street or - even worse - the reasonable hedge will be avoided due to accounting restrictions.

Question 3 - Derivatives that qualify for designation as hedged items (paragraphs 15, B9 and BC48–BC51)

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 agree that a synthetic exposure may be designated as a hedge item. This proposal will eliminate an unnecessary restriction of IAS 39 and therefore contribute to align hedge accounting more with risk management practices.

Question 4 - Designation of risk components as hedged items (paragraphs 18, B13–B18 and BC52–BC60)

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 welcome the proposal to allow the designation of a risk component as a hedged item if it is separately identifiable and measureable. But we question the decision to prohibit the designation of inflation components and credit risk as a hedged risk component. We see this restriction as a contradiction of the principle-based approach and to some degree as a discretionary decision.

Question 5 - Designation of a layer component of the nominal amount (paragraphs 18, B19–B23 and BC65–BC69)

(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 that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item, as this will allow entities to align their financial reporting closer to their risk management strategies.

(b) We understand that if a layer component of a contract that includes a prepayment option is allowed, this would result in designation of a risk component that is not separately identifiable. However, we believe that, at a portfolio level, it may be possible to separately identify the risk component and facilitate the measurement of hedge effectiveness. Therefore this question must be carefully reconsidered for the proposals on macro hedges.

Question 6 - Hedge effectiveness requirements to qualify for hedge accounting (paragraphs 19, B27–B39 and BC75– BC90)

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 fully agree with the removal of the 80 to 125 per cent bright line for assessing and measuring hedge effectiveness. This proposal is a simplification for the implementation of hedge accounting and a valuable improvement of the standard.

Furthermore, we support the Board not specifying a method for assessing whether a hedging relationship meets the hedge effectiveness requirements, thus permitting both qualitative and quantitative assessment.

Question 7 - Rebalancing of a hedging relationship (paragraphs 23, B46–B60 and BC106–BC111)

(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) and (b) In general, we agree with the proposals on rebalancing, because it enables an entity to reflect in hedge accounting the changes in hedge ratio that it makes for risk management purposes.

Question 8 - Discontinuing hedge accounting (paragraphs 24, B61–B66 and BC112–BC118)

(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?

(a) We agree with the proposal.

(b) The ED clarifies that an entity cannot voluntarily interrupt a hedging relationship, if the criteria for hedge accounting continue to be met. In contrast to the Board, we believe that an entity should be allowed to discontinue hedge accounting. Prohibiting voluntary dedesignation is inconsistent with the option to designate a hedging relationship at inception. Furthermore, since risk management is not defined and risk management policies may be changed at any time, an entity can discontinue hedge accounting freely.

Question 9 - Accounting for fair value hedges (paragraphs 26–28 and BC119–BC129)

(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?

(a) and (b) We do not support the proposed accounting treatment. The cost benefit aspect should be taken into account more. We also question the information advantage. Furthermore, we do not support linked presentation where gross assets and gross liabilities that are related by way of a fair value are presented together on the same side of the statement of financial position.

Instead we would suggest to aggregate all fair value hedge adjustments into a single net amount to be reported on the assets or liabilities side of the statement of financial position, depending on its balance.

Furthermore, we would like to emphasise again the need to consider the conceptual question as to which items must or may be presented in other comprehensive income and whether, when and how items of other comprehensive income come must be reclassified to profit or loss. We do not think that it is appropriate to decide this question case-by-case without a conceptual framework.

(c) No comment.

Question 10 - Accounting for the time value of options for cash flow and fair value hedges (paragraphs 33, B67–B69 and BC143–BC155)

- (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?
- (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 (i.e. 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?

No comment.

Question 11 - Hedges of a group of items (paragraphs 34–39, B70–B82 and BC156–BC182)

Eligibility of a group of items as the hedged item (paragraphs 34, B70–B76, BC163, BC164 and BC168–BC173)

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 will not be able to comment on these proposals in full until we gain a better understanding of the Board's direction in respect of macro hedging.

But we believe that these proposals are a good example for the not always comprehensive congruence between accounting and risk management, because of the different perspective. A risk manager focuses on the group when hedging risks, but the accountant needs to focus on the accounting unit. Therefore a comprehensive link between risk management and financial reporting is not possible under all circumstances. The ED proposes that a group of items is an eligible hedged item only if it consists of items (including components of items) that individually are eligible hedged items. This could mean that a restriction in accounting is a possible restriction for the hedging activities as well. This conclusion depends very much on the individual entity with its internal rules and regulations, but it is clearly an undesirable consequence.

Question 12 - Hedges of a group of items (paragraphs 34–39, B70–B82 and BC156–BC182)

Presentation (paragraphs 37, 38, B79–B82 and BC174–BC177)

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 disagree with the ways gains or losses from fair value hedges of net positions are proposed to be presented. Rather than requiring presentation on a gross and disaggregated basis in the statement of financial positions, we would recommend that all fair value changes be aggregated into a single item in the statement of financial position. For us the presentation in a separate line item is counterintuitive, because the hedging activity is the matching of separate risk position. And therefore the useful information in this context is the balance or the ineffective part of the hedge.

Question 13 - Disclosures (paragraphs 40–52 and BC183–BC208)

(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) and (b) We believe that the proposed disclosure requirements will lead into an information overload in particular for insurers and other financial institutions. The new European Framework Directive on Solvency II obligates insurers to publish a separate risk report that includes a comprehensive overview of all risk management activities. In accounting a reference to this risk report is entirely sufficient for an understanding of an entity's risk management strategy and hedging activities. We recommend that for entities who publish a separate risk report which is subject to strong government supervision it should be allowed to reference to this report instead of double all information for accounting disclosures.

Furthermore it is not apparent how these disclosure requirements relate to IFRS 7. Should the IFRS 7 disclosures be complemented or replaced by the proposed disclosures? We recommend that the requirements in the ED are put into a clear context with already existing disclosures.

We are in particular concerned about the proposal that an entity shall provide information about how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows (40 (b)). To hedge certain risks is a conscious and strategic decision by the management of an entity, hence there is no need to show possible alternatives of this decision. We strongly question the use of this information for users, because the figures that may be presented in this disclosure are completely unfounded. There is no common comparison basis for this information, because already the option within the underlying makes a reasonable comparison impossible. The inclusion of "what would happen if"-scenarios in the disclosures is not meaningful for the users of financial statements.

Question 14 - Accounting alternatives to hedge accounting (paragraphs BC208–BC246)

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative (Appendix C and paragraphs BC209–BC218)

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?

No comment.

Question 15 - Accounting alternatives to hedge accounting (paragraphs BC208–BC246)

Accounting for credit risk using credit derivatives (paragraphs BC219–BC246)

(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?

We do not agree with the proposals. Many financial institutions use credit derivatives to manage the credit risk. We do not believe that there is anything special about hedges of credit risk that would make fail to meet the hedge accounting requirements under IAS 39 as well as under the ED. Rather, hedge accounting should be applied to hedges of credit risk if all requirements are met, and otherwise no special accounting requirements should apply.

Question 16 - Effective date and transition (paragraphs 53–55 and BC247–BC254)

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

We refer to our comments on the IASB's Request for views about *Effective Dates and Transition Methods*, where we propose initial application no sooner than the 1 January 2015. We support a single effective date for all new standards. Early adoption should be permitted.

Berlin, 15 March 2011