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## **Exposure Draft ED/2010/13 “Hedge Accounting”**

Dear Sir David,

Thank you for the opportunity to comment on the above exposure draft.

We welcome the IASB’s intention to bring risk management and hedge accounting into greater alignment. In our view, however, the proposals in their present form will achieve this only to a very limited extent. We also have concerns about the Board’s expectation that risk management strategies will be set at the level of the individual transaction. This is not the case in large financial institutions, where risk management is determined at a much broader, macro level. We are critical, among other things, of the proposed bans on voluntary hedge de-designation, on hedging credit risk with CDSs, on hedging FV-OCI financial instruments under IFRS 9 and on designating non-financial items and items without a predefined maturity using models which take into account their behavioural or risk characteristics for the purpose of determining the entity’s risk position.

We are also critical of the fact that the ban on internal derivatives is to be retained. The use of internal derivatives is a key element of banks’ risk management. As a result of the ban, hedging relationships are continually designated and de-designated at present. But the IASB now

proposes making voluntary de-designation impossible, which would significantly limit banks' ability to reflect risk management activities in their accounts. It is not clear to us whether the practice of dynamic hedging would still be feasible in the future.

We basically welcome the planned ability to hedge groups of items. But the exclusion of instruments containing a prepayment option will pose significant practical problems. Many assets held by banks contain a prepayment option (e.g. property loans). The proposed exclusion would make it impossible to hedge interest rate risk in such cases.

We take a positive view of the proposed component approach, which would permit the designation of specific risks and risk components as underlyings. Nevertheless, we believe that principles-based requirements should apply throughout. It should be possible, for instance, to designate a LIBOR risk component of a financial instrument even if it has a negative spread to LIBOR (sub-LIBOR issue). Credit risk should also be eligible for designation as long as it can be identified as a separate risk and measured (at least more or less) reliably. It seems contradictory that an approximate measurement of credit risk by means of a credit default swap, for example, is not permitted despite the general principle allowing approximate measurements of a risk component with the help of a hypothetical derivative.

The proposal that non-derivative assets and liabilities measured at fair value through profit or loss should be eligible as hedging instruments has our support. We also support the removal of quantitative thresholds from effectiveness requirements since internal risk management is not geared towards limits of this kind. It is nevertheless unclear to us precisely how the measurement of effectiveness would function in practice. Aspects needing further clarification include the exact form of the effectiveness test and the requirement for "unbiased" presentation. There is also a lack of clarity concerning the practical implementation of rebalancing requirements and the designation of net positions.

It is regrettable that the exposure draft does not cover portfolio hedge accounting – a key issue for financial institutions. This makes it impossible for us to make a definitive assessment of the proposals in their present form. We believe it is essential for IFRS 9 to be evaluated in its entirety after all the proposed elements have been made public. Owing to the interaction between various aspects, this includes phases 1 and 2.

This point notwithstanding, our preliminary views on the questions raised in the exposure draft are as follows:

**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 welcome the intention to forge a stronger link between an entity's internal risk management activities and its financial reporting. Owing to the restrictions the IASB proposes, however, such as the bans on voluntary de-designation of hedging relationships, on using CDSs to hedge credit risk, on hedging financial instruments designated as at fair value through other comprehensive income under IFRS 9 and on using internal derivatives as hedging instruments, the desired objective will be achieved only in part.

Irrespective of this point, we believe that hedge accounting should not be mandatory but should be applied at the discretion of the entity – especially given the objective of greater alignment between hedge accounting and risk management. We would welcome it if hedge accounting were not limited to risks affecting profit or loss. Permitting hedge accounting for risks relating to equity and other comprehensive income too would be consistent with a principles-based approach.

**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?**

We welcome the extension of eligibility to these instruments. The key criterion for eligibility should not be the type of instrument; it should be whether or not the instrument can effectively hedge risk.

It is not clear to us, however, why financial instruments measured at fair value through other comprehensive income should not be eligible for designation as hedging instruments. Their exclusion is at odds with a consistent, principles-based approach.

### 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?**

We agree. Given possible implications for portfolio hedging, we would appreciate clarification of the following points, however:

- How are derivatives in the aggregated exposure to be handled if they are not hedging instruments? Are they then deemed to be held for trading?
- Can an aggregated position be designated as a hedged item only if two types of risk (e.g. interest rate risk and foreign currency risk) are managed together at a higher level?

### 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?**

We take a positive view of the extension of eligibility for designation. The proposed hedge accounting requirements nevertheless continue to diverge in important respects from banks' risk management practices. Take, for example, the ban on using CDSs to hedge credit risk or the long-standing sub-LIBOR issue, where the IASB intends to retain the existing restrictions in IAS 39.

Restrictions of this kind are at odds with a principles-based approach. As far as hedging credit risk is concerned, we would like to point out that market developments now allow credit risk to be separately identified and reliably measured.<sup>1</sup>

### 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?**

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<sup>1</sup> Cf., for example, D. Schubert (2009): Credit Solution, available at <http://www.risk.net/risk-magazine/analysis/1498070/credit-solution>.

**(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?**

We welcome the ability to designate layer components of the nominal amount as hedged underlying transactions, but disagree with the exclusion of instruments with a prepayment option. Firstly, a ban of this kind is inconsistent with a principles-based approach. Secondly, it would hit banks disproportionately hard. This is because banks normally manage risks at portfolio level. The ban on designating instruments with a prepayment option, by contrast, is based on a perspective focusing on individual transactions. We can understand the reasoning behind BC69 where single contracts are concerned because the behaviour of a loan with an embedded prepayment option cannot be predicted and, as a result, the whole range of possible scenarios has to be considered in the valuation of the option. But we do not agree that this problem applies to a group of hedged items or to portfolios.

In a portfolio, prepayment risk is assessed on a global basis to take account of the behaviour of all its constituent components. This means that below a measurable threshold based on historical data, the value of the prepayment option is nil however the yield curves move.

Under this approach, the bottom layer of the entire loan portfolio behaves as if no prepayment option were embedded. In these circumstances, the value of the prepayment option is nil.

The prepayment option issue thus has an influence on portfolio hedge accounting and should therefore be revisited by the Board in this context. We would also like to point out that, although the arguments surrounding the prepayment option were summed up well in IASB staff papers 10 ff. of November 2010, the Board failed to follow up the issue in depth.

## **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 rigid and artificial existing thresholds. Our understanding is that the retrospective effectiveness test has also been eliminated, which we strongly support. Additionally, we welcome the fact that no specific method for the effectiveness test is required.

In the future, qualifying criteria are to be geared more towards internal risk management objectives. A hedging relationship will be required to produce an unbiased result and minimise ineffectiveness. It is not clear, however, how “unbiased” is to be interpreted. The same goes for the term “minimise”. One possible interpretation would be that entities have to systematically adjust their derivatives positions so that they are always 100% effective. This is not the way internal risk management functions. Risk managers work within sensitivity limits (often with stop-loss triggers) and do not rebalance their books as long as they remain within defined targets.

In no event should the new requirements turn out to be more stringent than those in IAS 39.

### **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?**

Rebalancing is basically consistent with banks’ risk management practices in that hedging relationships are continually being adjusted (dynamic hedging). But the proposals in the exposure draft would lead to greater complexity, in our view. Since an entity’s economic strategies may sometimes change on a daily basis, it is difficult to pinpoint when the risk management objective is no longer hedging, but trading. The exposure draft does not make clear where the dividing line between risk management and hedge accounting should be drawn.

### **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?**

Please see our reply to question 7. Banks using dynamic hedging strategies designate and de-designate hedging relationships daily. One of the reasons for this is the IASB's ban on using internal derivatives, which it intends to retain. Instead of introducing the rules-based proposals on rebalancing, we would recommend retaining the ability to de-designate hedges voluntarily. We believe such an approach makes better sense and is even essential if there continues to be a ban on internal derivatives. This will avoid making requirements unnecessarily complex.

Furthermore, the ban also influences entities' abilities to align the accounting treatment of hedging relationships and their internal risk management activities. Given, as indicated above, that the IASB's proposals will not bring about an alignment of risk management and accounting, the ability to de-designate hedges voluntarily enables entities to reduce accounting anomalies and should consequently be retained.

#### **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 should it be presented?**

a) This is preferable to the Board's original proposals (i.e. the use of cash flow hedge accounting mechanisms for fair value hedge accounting). Nevertheless, it is likely to generate greater complexity compared to the current IAS 39 requirements and would necessitate costly

IT adjustments. We do not see how this approach would improve the usefulness of the reported information for users. Transparency about the results of hedging strategies is best achieved not by giving aggregate figures, but by providing appropriate details in the notes.

We would recommend a one-step approach under which ineffectiveness is recognised directly in profit or loss (i.e. without going through OCI).

b) We are less convinced by the idea of presenting the gain or loss on hedge items as separate lines in the statement of financial position. The proposed gross presentation will merely inflate the size of financial statements and risk overloading users with information. It would make better sense in our view to provide aggregate information in the financial statements and disaggregate information in the notes.

c) Yes, we agree.

#### **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?**

**(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 (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?**

a) Yes, we agree.

b) Yes, we agree.



c) The aligned time value requirement would generate complexity without portraying the relationship between the hedged item and the hedging instrument in an appropriate manner. Though we understand what the IASB is trying to achieve with this approach, we believe a detailed cost-benefit analysis is first needed.

### **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?**

Since banks manage their exposures on a net basis, these proposals are an improvement on the existing requirements of IAS 39. We are nevertheless not clear about the requirement to designate gross positions (cf. B73). This seems aimed solely at corporates (see examples).

The IASB's interpretation of "groups of items" generally seems to be based on a very rigid view of portfolios at odds with the dynamic way in which banks manage their portfolios in practice. Portfolios do not remain in a rigid, unchanged form until maturity but are adjusted sometimes on a day-to-day basis.

We are unable as thing stand to make a definitive assessment of this point because the IASB has yet to publish its conclusions/proposals on portfolio hedge accounting.

### **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?**

The main objective of banks' risk management is to hedge net exposures after underlying transactions have been offset against each other. The offsetting transactions affect various profit or loss positions. Since risk management activities are largely concerned with interest rate risk, the hedged risk merely affects different sub-items of interest expense and interest income. It therefore makes little sense to itemise the presentation of hedging gains or losses on these interest-related sub-items in the profit and loss account; details should instead be disclosed in the notes.

Furthermore, banks normally manage risk not by class of risk but across all interest-bearing financial instruments. As a result, it is only possible to give an approximate breakdown of contributions to profit or loss by net position and a number of problems of delineation would be raised by such an approach. As we see it, therefore, the proposed breakdown of gains or losses by net position would run counter to the objective of bringing hedge accounting and risk management into greater alignment. It is also open to question whether the proposed breakdown would provide users with added value in terms of useful information.

We believe the decision usefulness of hedge accounting information could be enhanced more effectively by consolidating the gains and losses on hedging instruments recognised in profit or loss into one position and indicating that further details can be found in the notes.

As mentioned in our reply to question 11, we will only be able to make a definitive assessment once the proposals on portfolio hedge accounting have been published.

### **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) We welcome the proposal to allow entities to incorporate certain information by cross-reference. We also welcome the proposed inclusion of disclosure requirements in the existing IFRS 7 requirements. By contrast, we do not agree with the planned extension of disclosure requirements to cover all the risks managed by the entity even if they are not hedged or subject to hedge accounting. In our view, compliance with this requirement will prove highly onerous while delivering little corresponding benefit. The past performance of hedging strategies has little predictive value as it relates to former exposures; any indication of existing risks would be purely coincidental. Moreover, we are not aware that users of financial statements have issues with the existing disclosure framework for hedge accounting and, as a result, do not see the value of the proposed changes. In addition, collation of the proposed disclosures would place a heavy administrative burden on preparers.

b) We do not believe that appropriate disclosures can be decided on until the issue of the linkage between risk management and hedge accounting has been decided (i.e. after phase 2). As a result, we are not able to respond to this question. The wording of the final disclosure

requirements should not be too prescriptive so that entities have sufficient flexibility to provide an adequate portrayal of the various circumstances in which risk management strategies have been developed.

#### **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?**

No comments.

#### **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?**
- (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 believe that hedge accounting should be permitted. As mentioned above, we take the view that hedge accounting requirements should be principles-based. This means that, if entities hedge credit risk separately internally, the same treatment should be applied in hedge accounting. Please also see our reply to question 4.

If the final standard does not permit hedge accounting, we consider alternative 3 the most preferable of the options discussed.

#### **Question 16**

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

We do not consider it feasible to implement the proposals by 2013, especially given that portfolio hedge accounting requirements have yet to be decided. We would therefore

recommend requiring the application of IFRS 9 in its entirety only from 1 January 2015 at the earliest. This date is conditional on the IASB concluding its projects (including portfolio hedge accounting) as currently planned.

We would also like to point out that exclusively prospective initial application from a specific date - especially of the new IFRS 9 classification requirements – could result in inaccurate presentation of entities' financial situation and profitability (in the sense of a true and fair view). When phase 1 is implemented, it may be assumed that some financial assets and liabilities will have to be classified (and measured) differently than was the case under IAS 39. IFRS 9.7.2.1 requires classification requirements to be applied retrospectively. This means, for instance, that for financial instruments which are designated voluntarily as at fair value through profit or loss under IAS 39 but classified as at amortised cost under IFRS 9, the amortised cost will have to be calculated at the time of initial application (unless use can be made of the exception under IFRS 9.7.2.10 on the grounds of impracticability). If this financial instrument was hedged from an economic perspective by a derivative (e.g. an interest rate swap), there was no need to apply hedge accounting requirements under IAS 39 because the fair value measurement of both instruments meant that no interest-rate related accounting mismatch arose from interest rate risk. If, however, the financial instrument had always been measured at amortised cost, the preparing entity would have already applied hedge accounting requirements to the economic hedge. The proposed exclusively prospective application of hedge accounting requirements would eliminate this option for preparers.

Against this backdrop, we would recommend more extensive and clearer transitional arrangements. We believe the transition requirements should be less restrictive so that an appropriate changeover to the future hedge accounting requirements can be ensured and, in particular, new accounting mismatches can be avoided.

Yours sincerely  
on behalf of the Zentraler Kreditausschuss,  
Bundesverband deutscher Banken



Dirk Jäger



Ingmar Wulfert