

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

9 March 2011

Dear Sir David,

**Exposure Draft ED/2010/13
Hedge Accounting**

Standard Chartered PLC (the Group) is an international banking group listed on the London, Hong Kong and Bombay stock exchanges. It operates in more than 70 countries, principally in Asia, Africa and the Middle East.

We welcome the opportunity to comment on the above exposure draft (ED) and our detailed responses to the questions are set out in the attached Appendix. We believe that this ED moves the accounting standards related to hedge accounting in the intended direction of simplification, but as detailed in our responses to the questions in the ED, we believe that more could be done to simplify hedge accounting for the hedges most commonly entered into by most reporting entities. It is important to understand that many governance committees have adopted prohibitions against their entity entering into derivative contracts unless they are used in a compliant hedge. While many argue that this is placing accounting treatment in front of the business case for entering into a transaction and therefore misguided, it nevertheless is the state of affairs for many of our clients today. Therefore whilst simplified, we believe that effective hedge accounting principles are needed to facilitate sound risk management. The Board's linkage of the hedge accounting standards to actual risk management practices is commended.


In addition we would like to provide some overarching comments:

1. We urge the Board to consider whether elements of the implementation guidance to IAS 39 should be retained. For example, the guidance on evaluating whether a forecast hedged item meets the requirement to be highly probable and on "all in one" hedges would still have value under the proposed standard.
2. We urge the Board to establish an IFRS 9 Implementation Guidance function to address issues that reporting entities, financial institutions, auditors, and other stakeholders could address to this function. IFRIC would be unlikely to be able to address the volume of issues that will be raised in relation to this new standard on a timely basis. This function ideally would be converged with a US GAAP equivalent or done jointly.

3. The Board has proposed that derivatives that are embedded in hybrid contracts but are not separately accounted for cannot be designated as hedging instruments. We urge the Board to revisit the requirements of IFRS 9 with respect to classification and measurement of financial assets. In our view, allowing bifurcation of embedded derivatives in financial assets would enable accounting to more closely reflect how risks are actually managed by banks. It would also eliminate the illogical treatment in IFRS 9 whereby one party to a transaction would bifurcate and therefore could use the embedded derivative as a hedging instrument, whereas the counterparty to the same instrument would not be allowed to do so.
4. The issue of hedging credit risk is of critical importance to the Group and most other financial institutions. We do not find the solutions proposed in this ED satisfactory, and we set out three more viable solutions in our response to question 15 that we believe would provide for sound accounting and which mirrors the risk management practices used in the industry. The use of the fair value option would not be seen as reflective of those practices and would not provide a proper reflection of the economic substance of the risk management practices employed.
5. The use of critical term matching and the hypothetical derivative method are widely used in practice and we commend the Board for acknowledging their validity in the ED.
6. We would encourage the Board to include greater guidance in relation to net investment hedges including at a minimum existing relevant guidance contained in IFRS.
7. We urge the Board to work with the FASB to align IFRS and US GAAP. Divergence on this topic is of no benefit to preparers or users of financial statements.

We would be pleased to provide any additional information or clarification of our comments if you so wish.

Yours sincerely,



Chris Innes-Wilson
Head, Group Accounting Policy & Advisory

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?

Lack of an overall objective in IAS 39 for hedge accounting has not been seen to be an impediment to achieving hedge accounting. The proposed objective is consistent with what hedge accounting is used to achieve in practice, therefore we agree with the proposed wording which links hedge accounting with an entity's risk management activities.

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?

In our view this had not been seen in practice as a constraint in achieving hedge accounting under IAS 39. However we do not object to this being permitted.

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?

Yes, we agree that an aggregated exposure (i.e. a combination of a non-derivative instrument and a derivative) may be designated as a hedged item. We note that hedging aggregated exposures are common for entities which hedge multiple risks of an underlying exposure using more than one derivative. Typical scenarios are hedges of commodity price risk and foreign currency risk, and hedges of foreign currency liabilities where an entity swaps into a combination of fixed and floating cash flows.

Whilst we support the Board's proposal we have significant concerns that the exposure draft does not provides clarity as to:

- 1) in what circumstances an aggregated exposure qualifies for hedge accounting
- 2) what the accounting mechanics for accounting for a derivative included in an aggregated exposure would be.

It is not clear that the change would reduce complexity compared to IAS 39 and could lead to divergence in practice.

For example, a derivative may be aggregated with a non-derivative exposure and a second derivative used as a hedge of that aggregated exposure, but for only a portion of the tenor of the aggregated exposure. Under IAS 39 the first derivative could be designated in two hedging relationships - one as the sole hedging instrument and one in combination with the second derivative. The hedged item in both cases would be the non-derivative exposure.

Under the proposed changes, the first derivative could be designated for a portion of its tenor as a hedging instrument, and for the remaining tenor as an aggregated exposure in combination with part of the non-derivative exposure, with the second derivative as the hedging instrument of the aggregated exposure. This is in our view, may be no less complex to apply, nor more readily understandable than the current requirement under IAS 39. We urge the Board to provide greater clarity and guidance on the intended accounting treatment in such cases.

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 agree that an entity should be allowed to designate risk components which are separately identifiable and reliably measurable. This brings non-financial items on par with financial items and we expect that this will result in hedge accounting for non-financial items better reflecting risk management practices and outcomes.

We would also like the Board to explicitly permit the hedged risk in a hedge of interest rate risk to be designated as the risk inherent in the hedging instrument. For example, in the case of an interest rate swap designated as a hedge of interest rate risk in a debt instrument, that the hedged benchmark risk could be designated as the swap risk, rather than for example, the risk free rate. In our view this would significantly reduce complexity in accounting for interest rate hedges.

We note that paragraph 8 permits separating the interest element and the spot price of a forward contract and designating only the spot element of a forward contract. However in BC102 the Board proposes that the time value of ineffectiveness of money must be considered when measuring the ineffectiveness of a hedging relationship. We consider that this is inconsistent with a “spot risk” designation. It is common practice for effectiveness testing for spot risk to be on an undiscounted basis – this is particularly useful when the timing of a hedged item is unknown. Introducing time value introduces complexity and also appears inconsistent with permitting spot as a hedged risk. We propose that the Board permit effectiveness testing to be on an undiscounted basis when spot is the hedged risk.

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 that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item as this is already common practice under IAS 39 as a cash flow hedge.

- b) We agree that a layer component 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 as the risk component would not be separately identifiable.

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?

Objective of hedge effectiveness assessment

Paragraph 19(c) and B27 require that for a hedge relationship to be effective the fair value or cash flows of the hedging instrument must be expected to achieve other than accidental offsetting in the fair value or cash flows of the hedged item.

However B29 goes on to state that the objective of the hedge effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and minimise hedge ineffectiveness.

We disagree with this definition of the objective of the hedge effectiveness assessment. Only the hedging instrument which most perfectly hedges the hedged item will ensure hedge ineffectiveness is minimised and implies that no other hedging instrument will be able to achieve hedge accounting. This wording also appears to contradict B29 which does go on to say "this does not mean that a hedging relationship has to be expected to be perfectly effective in order to qualify for hedge accounting".

We do not believe this is the Board's intention and this is evidenced by the removal of the 80-125% bright line for effectiveness testing – which we support. We therefore urge the Board to remove this wording. We suggest that this wording could be replaced by "reduce hedge ineffectiveness".

Critical terms matching

Paragraph B34 states that when the critical terms of the hedging instrument and the hedged item match or are closely aligned it might be possible for an entity to conclude on the basis of a qualitative assessment of those critical terms that the hedging relationship will probably achieve systematic offset and that the hedge ineffectiveness, if any, would not be expected to produce a biased result.

In our view the Board should change the wording above to state that when critical terms match "it will be possible" rather than "it might be possible" such that when critical terms match no quantitative test is required. This is supported by BC87(a) which addresses hedges which have matched, or closely matched terms. In this BC the Board uses the language that "if there are no substantial changes in the critical terms or in the credit risk....effectiveness can typically be determined using a qualitative assessment". However in our view matching of critical terms should be sufficient in all circumstances.

We would also extend the matching of critical terms criteria for effectiveness measurement ie. for use as a short cut for effectiveness measurement of 100%. The vast majority of risk management strategies actually use hedging instruments which perfectly match the hedged risk – however the

accounting outcome does not reflect this. For example, consider a receive-fixed interest rate swap which is designated in a fair value hedge of fixed rate debt. The receive fixed leg of the swap offsets perfectly the fixed rate debt, but changes in the fair value of the pay floating leg of swap result in ineffectiveness as there is no offset in the debt. We propose allowing a short cut approach for cash flow and fair value hedges, based on the criteria established in US GAAP which has been commonly used as a critical terms match checklist for IFRS. We are aware that this is a common method used for effectiveness testing under IAS 39 (subject to a cursory check that the hedging instrument counterparty is still expected to honour the contract), and for effectiveness measurement.

Hypothetical derivative

Paragraph B44 defines a “hypothetical derivative” as a derivative that would have terms that match the critical terms of the hedged item and would be at the money at the time of designation of the hedging relationship.

We propose that an entity should be able to define a hypothetical derivative which has terms that match the critical terms of the hedged item but is not required to be at the money at the time of the designation. This would be consistent with the existing language in IAS 39, IG F.5.5. For example if an entity does not designate a derivative in a hedging relationship at the trade date, the fair value of the derivative at the designation date can lead to ineffectiveness being reported. Similarly, when a hedging instrument is acquired in a business combination there may be significant ineffectiveness reported if the value of the hedging instrument is not close to zero. As the hypothetical derivative is used to measure the change in value of the hedged item, not the absolute value, permitting this would enable such hedge accounting to better reflect the underlying risk management in these circumstances.

Therefore where a hedging accounting relationship is entered into after inception of a derivative hedging instrument, we assert that the hypothetical derivative should be defined as the derivative which perfectly hedges the hedged item from origination of the hedged item. This is what is indicated in IAS 39, IG F.5.5. The ED states that the hypothetical perfect derivative must have a nil value at the time the hedge is designated. We believe that is only valid when the hedge is designated at the same time the hedged item and hedging instrument are entered into and not when the hedge is later designated. The impact of this would be that where a cash flow hedge is entered into and is a perfect hedge, any amount already recognised in P&L on a cumulative basis would be reversed and instead recognised in the cash flow hedge reserve, and in a fair value hedge the accounting entry would be to adjust the hedged item for the change in fair value of the hedged risk on a cumulative basis to date. Since the hypothetical derivative is a matter of fact we do not believe that this provides opportunities for “cherry picking” but rather is a consequence of permitting hedge accounting to be an option rather than mandatory for economic hedging relationships. Once a hedge relationship is entered into we would then prohibit de-designation so long as the hedge is consistent with management’s risk management strategy and the hedge relationship is intact.

B26 of the ED would permit an entity to designate a component equal to a benchmark rate that is higher than the contractual benchmark paid on a fixed rate financial instrument, which is hedged some time after its origination. This is only permitted provided that that benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day when it first designates the hedged item. The example goes on to explain that the entity

can designate a higher LIBOR component as this consists partly of contractual interest cash flows and partly the difference between the current fair value and the amount repayable on maturity. We see no reason why an entity should be prohibited from designating a lower benchmark rate in the same circumstances, as this would represent the decrease in the current fair value and the amount repayable on maturity and the contractual interest cash flows. It would appear that the logic being applied here is to that of a cash flow hedge and the concern would be whether the cash flows would match, but the issue involves a fair value hedge. Even if it were a cash flow hedge, the logic would not apply as what is hedged is the variability in cash flows and that would not be impacted by the valuation of future cash flows.

Designating the risk inherent in the hedging instrument as the hedged risk

Probably the easiest and most logical way to achieve the stated goal of this ED to make hedge accounting simpler and more principle based would be to provide that if the hedged risk is designated as the risk inherent in the hedging instrument and the hedged risk is substantially present in the hedged item then the hedge is deemed a perfect hedge and the change in fair value on the hedging instrument is used as the movement on the hedged item. This would be limited to hedging relationships with critical terms matched. For example, a fair value hedge of a fixed rate debt instrument hedged with an interest rate swap would have the hedge risk designated as the swap curve of the interest rate swap. This eliminates the need for testing effectiveness and measuring the hedged risk in the hedged item. The same concept would be applied for a foreign currency debt instrument hedged with an FX forward contract. This eliminates the interim volatility created by differences between spot and forward rates that will be the same when the end of the hedge period and hedge accounting is suppose to reflect the impact of the relationship over that period and not intermediate periods, making this more consistent with the principles.

Alternative simplified approach

Alternatively, a significant simplification for accounting would be to permit simple derivatives which are designated in effective hedging relationships to be accounted for using a linked approach. For example an interest rate swap would be accounted for using accrual accounting for each leg, an FX forward contract would be accounted for by applying the contract rate as the closing rate for the hedged item, and a CDS would be treated as collateral and the cost would be amortised. This was largely the approach applied prior to IAS 39. This would reduce the complexity of applying hedge accounting for these derivatives. This could be a practical solution for all entities, or at least for SMEs as it would eliminate the need for complex valuations – unless fair value is disclosed - and reflect the cash flows of the economics of the transaction.

For these derivatives (or proportions of them) we propose that their fair value would be required to be disclosed but not recognised. The hedge designation would be required to demonstrate a linking of the hedged item and the derivative however there would be no requirement to measure ineffectiveness. This would be similar to permitting critical terms matching for effectiveness, however goes further than this as it would also simplify the accounting entries.

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) If the risk management objective remains the same, in our view compulsory rebalancing of the hedging relationship is appropriate only if this would be required to ensure that the hedge is still expected to be effective in the future.

b) We consider that proactive rebalancing prospectively should be permissible, but not mandatory.

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 agree that once a hedging relationship is designated it should continue to be accounted for as a hedge, consistent with the risk management objective.

Under IAS 39 in order to force a hedge to fail, it was possible for an entity not to perform an effectiveness test and therefore fail to meet the requirements for hedge accounting to continue. The proposals in the ED would make it mandatory to test effectiveness once the hedge designation has been made. However we consider that this is not dissimilar to other mandatory accounting requirements, such as performing impairment tests when required.

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) We agree that financial reporting will be less complex if fair value hedge accounting adjustments on the hedging instrument and hedged item are recognised in OCI. This will collect hedging adjustments for both fair value hedges and cash flow hedges in the same place in the financial statements. Since risk management strategies are generally not classified as cash flow or fair value strategies, in our view it makes sense to align the accounting for both.
- b) We do not 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. The purpose of hedge accounting is to permit linking items reported in the financial statements which would otherwise be accounted for separately. Our preference is therefore to show the gain or loss on the hedged item, together with the hedged item itself using linked presentation. An alternative to this which we consider would also be acceptable would be to show a net number on the balance sheet (including the gain or loss on the hedged item attributable to the hedged risk) and disclose in the notes the split of the underlying hedged item and the gain or loss).

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?

In our view, all of the proposed solutions for accounting for options do not reduce complexity. In our opinion the vast majority of economic hedge strategies which employ options, are of the "critical terms match" type. The simplest accounting approach is to apply the US GAAP DIG G20 solution ie. the time value of the option is recognised in OCI. For option hedges which are not perfectly matched, some ineffectiveness would be recognised. This could be most simply measured using a comparison to a hypothetical option derivative. This would be a less complex solution than those proposed by the Board.

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 eligibility of groups of items as a hedged item.

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?

We agree that where a net position hedge affects different line items in the income statement the gain or loss on the hedging instrument should be presented in a separate line.

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,b) Linking the disclosures about hedge accounting to the risk management practices of the entity is welcomed as this should give greater focus on the overall hedging strategy of management, rather than just financial instruments used for hedging which are held at balance sheet date.

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?

We agree that using derivative accounting for such contracts will improve financial reporting by presenting these contracts in a manner which is more reflective of an entity's risk management practices and consistent with actual derivative contracts when these are managed together.

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 do not consider that any of the three alternative accounting treatments proposed would reduce complexity or improve the quality of financial reporting. We believe that the principles related to the hedging for credit risk could be made very simple and straightforward thereby facilitating the hedge accounting of credit risk. We have provided three proposals below that we believe would be both simple and consistent with sound accounting principles:

1. Allow for a credit derivative to be accounted for as a financial guarantee provided the entity has a contractual arrangement that exposes it to losses that would be incurred, whereby the credit derivative would require the issuer to make specified payments to reimburse the entity for a loss it incurs because a specified debtor fails to make payment when due, in accordance with the original or modified terms of that contractual arrangement.

This approach would result in the credit derivative being outside the scope of IFRS 9 and practice would be to amortise the cost of the credit derivative and to treat the credit derivative asset as collateral in assessing the related debt instrument.

This would result in the credit derivative being accounted for in manner that reflects economic reality as they in substance serve as collateral and not as a speculative financial instrument when the underlying credit exposure is present.

2. Simplify the requirements for fair value hedge accounting treatment by allowing for the designation of the hedged risk as that of the credit risk inherent in the credit derivative when the critical terms are substantially identical in the hedged item and hedging instrument and the hedged risk relates to a failure to make payment when due on a credit exposure of the entity.

This approach results in the fair value measurement of the credit derivative being used to measure the credit risk inherent in the hedged item, even though it would be acknowledged that they would not be identical. A credit derivative contains not only the credit risk specified in the contract, but also that of the issuer of the credit derivative. Clearly, the issuer credit risk would not be found in the hedged item, but this secondary credit risk is generally insignificant.

What this approach resolves is the perceived problem of not being able to reliably measure the credit risk component of the hedged item. As hedge accounting should be looked at over the life of the arrangement, this approach will reflect the economic reality that, although the fair value of the credit derivative may vary over its tenor, it will either expire with no value as the hedged item delivers the contractual cash flow specified or the credit derivative will have a value equal to that of the contractual cash flows that have been defaulted on by the counterparty to the hedged item.

3. Clarify that the credit derivative that will fully offset the specified cash flows of a hedged item is a perfect cash flow hedge of the credit risk related to those specified cash flows if the critical terms are matching.

Discussions of hedging credit risk under IAS 39 have focused solely on using a fair value hedge and the issues of reliable measurement and therefore the ability to measure hedge effectiveness. A cash flow hedge solution has been met with objections centering around the risk being contingent, the hypothetical perfect derivative being a financial guarantee and that the change in fair value of the designated risk of the hedged item is not be reliably measurable and therefore effectiveness cannot be proven.

We consider that the argument regarding this being a hedge of a contingent risk has no merit. The hedged risk is the variability in the highly probable cash flows specified in the hedged item due to a failure to make payment when due as defined in the hedging documentation. That is not a hedge of a contingent cash flow, but rather of the variability of a contractual cash flow.

Likewise, we believe that the argument that a hypothetical perfect derivative would be a financial guarantee also has no merit. The only difference between a credit default swap and a financial guarantee with identical critical terms would be the requirement in the financial guarantee that the loss be incurred in order to be compensated. That would not have any impact on a hedging relationship as this is implicit in a hedging relationship whereby the cash flows on the hedged item

must be offset by those of the hedging instrument. A credit default swap would be the hypothetical perfect derivative as long as it replaced the specified hedged cash flows.

Finally, the argument that the change in fair value of the designated risk of the hedged item would not be reliably measurable, and therefore effectiveness could not be proven, assumes that the fair value must be reliably measured when in fact either the fair value or cash flows must be reliably measurable. This argument is inconsistent with IAS 39, AG99F which states that to be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the cash flows or fair value of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. Moreover, the variability in cash flows related to the hedged risk can be reliably measured and in the case of performing debt instruments is generally either all or nil, as a default event will trigger an immediate need to repay all contractual cash flows.

Further to this issue, an IFRIC discussion in March 2007 is pointed to as evidencing that fair value measurement must be used to measure hedge effectiveness. The issue IFRIC addressed was in relation to a cash flow hedge of interest rate risk using an interest rate swap and whether hedge effectiveness related to qualifying for hedge accounting could be assessed by simply scheduling undiscounted cash flows on the floating leg of the swap against the like leg of the hedged item. IFRIC objected to this, as this ignored the fixed rate leg of the swap and effectively bifurcated the swap which is not allowed. Whilst this is consistent with IAS 39, IG F.5.5, the rationale articulated by IFRIC for rejecting the issue is far less comprehensive than the IAS 39 guidance, with the unintended consequence of it being read out of that context.

This is the relevant section of IAS 39, IG F.5.5:

It also should be noted that it would be inappropriate to compare only the variable cash flows on the interest rate swap with the interest cash flows in the debt that would be generated by the forward interest rates. That methodology has the effect of measuring ineffectiveness only on a portion of the derivative, and IAS 39 does not permit the bifurcation of a derivative for the purposes of assessing effectiveness in this situation (IAS 39.74). It is recognised, however, that if the fixed interest rate on the interest rate swap is equal to the fixed rate that would have been obtained on the debt at inception, there will be no ineffectiveness assuming that there are no differences in terms and no change in credit risk or it is not designated in the hedging relationship.

The implementation guidance makes it clear that there would be effectiveness if the hedge was designated as a hedge of the current fixed market rate. This is because the difference between the fixed rate inherent in the swap and the current market rate would be reflected in income at inception and not be included in the hedging relationship. IFRIC did not make it clear that a cash flow hedge would be perfectly effective if there were no change in the credit worthiness of the hedging instrument issuer and if the hedged risk matched the terms of the hedging instrument at the inception of the hedging relationship. Also, IFRIC's discussion leads to an interpretation that assessing hedge effectiveness for application of applying hedge accounting and measuring hedge ineffectiveness are one in the same. This would be inconsistent with the implementation guidance.

We consider that a reporting entity should be able to evidence that a hedge is expected to be effective by demonstrating that the variability in cash flows related to a hedged risk are expected to be offset by the variability in cash flows of the hedging instrument over the life of the hedge. We propose that this should be clarified in the revised standard. This would significantly reduce the onerous effectiveness testing requirements for these types of hedges.

Applying the IAS 39 implementation guidance, in this context, to credit default swaps results in perfect effectiveness being evident as long as the credit worthiness of the issuer has not changed after the issuance of the swap. We have proposed above in our response to question 6 that when critical terms match there need be no ineffectiveness measured. However if the Board rejects that proposal, measurement of ineffectiveness would be by a method takes into account the terms of the hedging instrument in relation to market rates or prices.

It would be desirable for the Board to clarify what the Board intended with regard to hedging credit risk as IAS 39 clearly shows credit risk as a risk that may be hedged, while practice has been to prohibit the hedging of credit risk based on the issues shown in the ED and above. This is contrary to the objectives of IFRS to reflect economic reality in the accounts of the reporting entity.

Question 16

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

We generally agree with the proposed transition requirements, but ask the Board to consider allowing for the early adoption of the revisions related to Hedge Accounting without early adopting the other provisions of IFRS 9 as it appears that the revisions related to this topic are not as much of a change in the accounting standards as a clarification of the existing standard.