



The voice of banking  
& financial services

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

12<sup>th</sup> March 2010

Dear Sir David,

**ED/2010/13: Hedge Accounting**

This is the British Bankers' Association's response to the above exposure draft; we welcome the opportunity to comment.

We continue to be supportive of the Board's project to replace IAS 39 and welcome this step towards the completion of that project. We view a number of the proposals in the exposure draft positively believing that measures to align hedge accounting more closely with risk management and to remove some of the inconsistencies and weaknesses in the current model are appropriate. It is difficult, however, for us to assess the proposals without sight of the macro-hedging regime and therefore reserve our final judgement until we can assess the comprehensive model.

We support the IASB's overall objective to link hedge accounting and risk management. Our main concern is how to make this operational as the guidance is not clear. It has an impact on how banks would apply the effectiveness test, rebalancing and discontinuation of hedge accounting arrangements. In order for the hedging proposals to be applicable to all industries and to remain operational, they need to be aligned to the level at which risk management exposures are aggregated, measured and reported to senior management. The ED seems to apply to the level of individual transaction, or is not clear about the unit of account. Banks have a high volume of hedging relationships; risk positions are hedged on an aggregate basis and therefore if the hedge accounting model is applied at a transaction level or even a portfolio level in some circumstances may be impossible to implement.

Other concerns over the proposals in the current ED relate to the proposals for presentation and disclosure. We do not support the proposed two-step approach to the recognition of the fair value gain or loss on a hedging instrument or that it should be presented in a separate line in the statement of financial position. A better approach would be to require all fair value adjustments to be displayed on one line, with disclosure used to provide more detail. Whilst some of the disclosures proposed appear necessary to provide users with an understanding of an entity's risk management strategy and hedging activities, much of what is proposed is overly prescriptive and, if adopted, is likely to result in the provision of large tracts of boilerplate disclosure of little value to users.

Our responses to the individual questions raised are provided overleaf.

## 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 of the new objective and agree that it opens the way for a more principles-based approach to hedge accounting, linked more closely to risk management activities. However, whilst the stated intention of the objective is welcome, a number of the proposals contained in the ED are rules-based and inconsistent with a standard intended to integrate with an entity's risk management activities. Not least is the restriction of hedge accounting to risks which affect profit or loss. This is inconsistent with the objective of aligning hedge accounting with risk management and with the IASB's concept of a single performance statement. To banks, and other companies, equity (and the attendant capital ratio) is as important to hedge as profit or loss and similarly many banks would also use financial instruments to hedge foreign exchange risk that they face on equity investments, whose fair value changes would, under IFRS 9 *Financial Instruments*, be recognised in Other Comprehensive Income with no recycling to profit or loss permitted.

We understand the Board's main concerns related to the practical issues that would occur in the matching of the fair value of the hedged item and the hedging instrument and the recognition of hedge ineffectiveness (see paragraph BC 23 of the ED).

We support the second alternative presented in the Basis of Conclusions (see paragraph BC 25), namely that ineffectiveness should be presented in profit or loss, consistent with hedge accounting principles. We also believe that presenting all hedge ineffectiveness in the same place in the financial statements will provide the most useful information to our investors.

We recognise that this contradicts the prohibition of reclassifying to profit or loss gains or loss on equity instruments accounted for at fair value through Other Comprehensive Income but believe that this would be an appropriate exception as is the case of dividends received on these investments.

The fair value and cash flow hedge accounting approaches exist to address particular types of recognition and/or measurement mismatches that are created by the financial reporting framework, in particular the mismatch between items held at fair value through profit or loss and those held at amortised cost. Therefore, the ED (like IAS 39) assumes the entity is either hedging exposures to changes in fair value or the potential variability of future cash flows. However, this is a hedge *accounting*, not a risk management approach

Furthermore, we are concerned that existing hedge relationships may be jeopardised by the risk management objective requirement. IAS 39 IG F.6.2 (a), permits an entity to apply hedge accounting independently of the economic purpose of the transaction. IAS 39 states that 'a receive-fixed, pay-variable interest rate swap can be considered to be a cash flow hedge of a variable rate asset or a fair value hedge of a fixed rate liability'. A separation from the economic / risk management objective is arguably encouraged in F.6.2(a) where it is stated that 'it is often easier to demonstrate high effectiveness for a cash flow hedge than for a fair value hedge', and our understanding is that many European banks apply cash flow hedging (of variable rate assets) even though their economic hedged item is fixed rate liabilities. We believe that the ED (notably B53) may be interpreted to mean that an entity must discontinue hedge accounting where the hedge relationship (involving variable rate assets) is not aligned to the entity's risk management objective (which relates to fixed rate liabilities) and would welcome wording to clarify that this is not the case.

**Comment [h1]:** Need to be clearer, or use as an example for the text provided

Forcing a risk management objective to fit to a particular type of hedge accounting approach may result in an entity trying to modify its risk management strategy to achieve a particular

hedge accounting mechanism. That is, risk management policy becoming subsidiary to hedge accounting – an outcome that is contrary to the objective in the proposals.

## 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 agree that non-derivative assets or liabilities measured at fair value through profit or loss should be eligible hedging instruments but would caveat that we do not believe it is common for financial institutions to utilise these instruments in their hedging activities.

## 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 welcome the decision to eliminate the unnecessary restriction in IAS 39 and to permit a synthetic exposure to be designated as a hedged item. This is consistent with the objective of the project to align hedge accounting with risk management.

## 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 (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 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 provided that the risk component can be separately identified and reliably measured.

We do not believe there to be conceptual grounds for prohibiting explicitly inflation and credit risk as being separately identifiable and measurable, in a principle-based standard. Moreover this contradicts the objective of the exposure draft to align hedge accounting with risk management. If an entity can separately identify and measure a risk component and is applying hedge accounting from a risk management perspective then they should not be precluded from applying hedge accounting.

However, we would underline the importance of the risk components being separately identifiable and measurable and suggest that further consideration may need to be given to when these criteria have been met. For example the movement in the hedged risk component cannot simply be equal to the movement in the hedging instrument. This would dispel an assumption that a credit default swap price simply mirrors the credit component of a loan. To be eligible, an entity must be able to demonstrate the different elements and inputs that contribute to the price and movement of the hedged component.

We would add that understanding the circumstances in which an entity may need to hedge debt instruments with negative indexation (the 'sub-LIBOR issue') is a matter on which the IASB needs to make progress within the context of macro-hedge accounting.

### 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?**

We broadly welcome the layer approach proposal as there may be uncertainty around the amount and timing of hedged items, and will assist those entities which manage their layer components in their risk management strategies.

However we also note that the proposals noted above may be helpful with entities with few hedging relationships, or for hedging relationships of non-financial items. As noted in the ED, when considering individual items, a prepayment option whose fair value changes in response to the hedged risk would result in ineffectiveness being misrepresented. However, the proposals are unlikely to provide any significant relief from either an operational perspective, or from the point of view of aligning hedge accounting with risk management, for entities that undertake significant hedging activities based around portfolios of financial assets, because of the restriction regarding prepayment options.

In such situations, the effect of prepayment options are modelled and managed by risk management in the context of the total portfolio, and not in the context of each individual asset. This approach permits the benefits of greater certainty about likely prepayments arising from a portfolio assessment. We believe that a workable solution for both fair value and cash flow hedging should be to allow for the hedging of bottom layers within the portfolio hedge accounting model. In such situations, to reflect risk management, prepayments should be taken from the top layer, allowing the bottom layer to remain "intact". We therefore urge the IASB to develop proposals for portfolio hedge accounting as a matter of urgency.

We also do not agree with paragraph B23 of the ED – that a prepayment option is not an eligible hedged item in fair value hedge if the fair value of the option is affected by changes in the hedged risk. To reiterate our response to Question 4, we do not consider it appropriate to make explicit exceptions for eligible hedged items, in a principles-based standard. An entity that can separately identify and measure changes in value due to prepayment risk and interest rate risk should be able to exclude the prepayment option.

### 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 quantitative threshold and the retrospective assessment of hedge effectiveness testing but believe clarifications are needed, not least of 'unbiased result', 'other than accidental offsetting' and 'minimise the expected hedge ineffectiveness'.

We also highlight that the removal of the bright lines (whilst welcome) will require new processes to be developed to enable auditors to gain assurance on hedge effectiveness in the absence of the quantitative measurements. This is not a criticism of the Board or proposed Standard, but an indication of the critical role that auditors will play in the way the proposals are implemented.

### 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?**

We believe that entities should be allowed but not required to rebalance the hedge relationship as this will reflect the dynamic nature of hedging and will enable an entity to reflect changes in a hedging relationship from a risk management perspective. A mandatory requirement to rebalance the hedging relationship, however, could have the unintended consequence of requiring an entity to transact derivatives purely to comply with the rebalancing requirement. The principle needs to be clear that an entity may rebalance but it should not be forced to do so. Rebalancing should always be supported by voluntary de-designation given the potential for hedging model to become very complex under the layering approach proposed in the exposure draft. Ultimately rebalancing should be aligned to an entity's risk management practice recognising that entities have varying degrees of tolerance for effectiveness, which reflect risk appetite, the cost of hedging and other practical constraints,

Further clarity is also required on whether rebalancing is restricted to changes in the hedge ratio. It is not clear if you can rebalance when the hedge ratio remains consistent but the volume of either the hedged items or the hedging instruments has changed. Often in the context of interest rate risk for, the hedge ratio is simply not relevant. It will always be 100%, or close to 100%.

### 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 disagree with the proposed prohibition on voluntarily discontinuing hedge accounting and would argue for the IAS 39 approach to be maintained. This is on the basis that we do not agree with the Board's logic (set out in BC117) that, if an entity initially qualified to use hedge accounting in accordance with its risk management objective, it is arbitrary and unjustifiable to voluntarily discontinue hedge accounting. This has no conceptual merit given that it is optional to apply hedge accounting in the first instance. We believe that this should remain a matter of accounting policy, with discipline provided via disclosure requirements.

A change in risk management strategy, however, should trigger the discontinuation of hedge accounting but only where it results in the hedge relationship no longer meeting criteria.

To reiterate our response to question 7, rebalancing proposals have the potential to become unduly complex, especially in a banking environment with risk exposures that can change on a daily basis. A hedge accounting model that only allows for rebalancing could result in a substantial number of layers of separate hedging relationships, which becomes very difficult to manage operationally. Thus rebalancing should also be supported by an ability to discontinue hedge accounting on a voluntary basis, to allow reasonable flexibility for an entity to discontinue hedge accounting relationships and replace with new hedge accounting relationships in line with their own risk management strategy.

#### 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?**

We are uncertain what benefit the proposed two step approach to the recognition of the gain or loss on the hedging instrument and the hedged item will deliver. A one step approach, i.e. dispensing with recognition in OCI, would be simpler and would still deliver the same net effect in the P&L.

We do not support the presentation of the gain or loss on the hedged item attributable to the hedged risk on a separate line item in the statement of financial position. We fail to see how this will improve clarity. A better approach would be to require all fair value adjustments to be displayed on one line, with disclosures used to provide a more detailed breakdown.

We agree that linked presentation should not be allowed for fair value hedges.

#### 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 (e.g. 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 a 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?

We welcome the proposals with regard to the accounting for the time value of options, which we believe may make options more attractive as a hedging instrument.

#### 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 proposed criteria.

#### 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 (e.g. 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, subject to the points made in response to question 9 regarding presentation.

#### 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?

We support the objective of the proposed disclosure requirements, i.e. that they should help users to understand the entity's risk management strategy and provide an insight into the entity's hedging activities. In our view, the disclosures outlined by paragraphs 40 – 43, 45, 47 and 48 achieve this. We do not agree, however, with the prescriptive nature of the wording in paragraph 44, the excessive requirements in paragraph 46 or the list of quantitative information required by paragraph 49 onwards. The quantity of information required is likely to be of limited decision-usefulness to users, particularly if it is presented in a boilerplate fashion. It is also not clear to us how the proposed disclosures fit with those required by IFRS 7.

In terms of additional disclosure requirements, as noted in response to question 9, we believe that the notes should be used to provide some of the information required by the ED.

#### 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?**

This is an issue for corporates.

#### 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 find the three alternatives approaches complicated and largely unhelpful. We do not understand why a simple hedge accounting solution cannot be applied to such relationships on a similar basis to that for interest rate hedges.

#### Question 16

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

As noted in our response to the recent paper on effective dates and transition methods, we believe that the mandatory effective date for the major standards currently under development should be set at 1 January 2015, with relief for the provision of prior year comparators. This will maintain comparability across the industry and reduce the significant systems burden.

We would be happy to provide further detail on any of the points raised in this letter.

Yours sincerely



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