

March 9, 2011

International Accounting Standards Board  
30 Cannon Street, 1<sup>st</sup> Floor  
London EC4M 6XH  
United Kingdom

Dear Board Members:

**Re: Exposure Draft – Hedge Accounting**

The Canadian Bankers' Association<sup>1</sup> ("CBA") would like to thank the International Accounting Standards Board (the "Board") for the opportunity to comment on the Exposure Draft (ED) *Hedge Accounting*.

We are supportive of the Board's decision to simplify certain aspects of hedge accounting and the efforts to address the inconsistencies and weaknesses in the existing hedge accounting model under IAS 39 Financial Instruments: Recognition and Measurement ("IAS 39"). We are supportive of the Board's effort to align hedge accounting more closely with risk management and to establish a more objective-based approach. Overall, hedge accounting is a small component of the overall risk management activities for a financial institution. Aligning hedge accounting with risk management will ultimately provide users of financial statements a more clear enterprise view of the institution and will be more efficient. Of particular interest to Canadian banks is the ability to designate in qualifying hedge accounting relationships its macro hedging strategies in a manner that will reflect its risk management practices. However, since the Board is continuing its discussions on hedge accounting for open portfolios or macro hedging and their treatment is not addressed in this ED, it is possible that we may change our views for some of the issues addressed in this ED when the Board publishes the macro hedging proposal. Therefore, we ask the Board to be open to additional comments once we have the opportunity to assess the hedge accounting model in totality. In Appendix B to this letter we have enclosed items we would encourage the Board to consider in developing its exposure draft on this topic.

While we are supportive of simplifying the assessment of hedge effectiveness, we do not agree with the Board's decision to remove or significantly limit an entity's ability to voluntarily de-designate hedging relationships, as this would significantly limit an entity's ability to apply hedge accounting (especially on a portfolio basis) without incurring unnecessary costs. Hedge accounting, by its

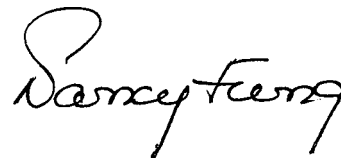
<sup>1</sup> The Canadian Bankers Association (CBA) works on behalf of 51 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 260,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy.

nature, is elective. Under the proposal, entities can only achieve the impact of de-designation by terminating (or offsetting) existing derivatives and entering into new derivatives. De-designation of hedging relationships is part of an entity's risk management activities. Therefore, restricting voluntary de-designation would not meet the Board's objective of linking accounting with risk management. We do not support removal of the ability to de-designate hedging relationships as this will add unnecessary costs to entities.

We also do not agree with the Board's view that credit risk is difficult to isolate and cannot be measured reliably. We believe that credit risk of certain financial assets, such as "plain loans" or "plain vanilla corporate bonds", can be separately identified and reliably measured, and entities should be permitted to hedge credit risk for these instruments. We are encouraged by the Board's efforts to address hedges of credit risk using credit derivatives but do not agree that all three alternatives should be rejected. We believe the approach to account for hedged credit exposure in alternative 3, discussed in BC 226(c), aligns with the credit risk management strategies of financial institutions. Entities should be permitted to apply this treatment in managing the credit risk when they do not qualify for hedge accounting. However, as discussed in our response to Question 15, we believe that the treatment of the measurement change adjustment (MCA) should be consistent for both loans and loan commitments.

We support the Board's effort to address the complexities in current hedge accounting guidance and also ask the Board to work with the FASB to develop a common global standard for hedge accounting that entities can practically apply to their risk managing strategies. We have expressed our primary concerns in our letter and provided responses to specific questions set out in the ED in Appendix A. We look forward to participating in further dialogue related to hedge accounting and would be pleased to discuss our position and concerns with the Board or its staff.

Sincerely,

A handwritten signature in black ink, appearing to read "Samy Fung". The signature is fluid and cursive, with the first name "Samy" and the last name "Fung" clearly distinguishable.

Attachments: Appendix A  
Appendix B

## Appendix A

### 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?**

Comments:

We agree that the objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities which uses financial instruments to manage exposures arising from particular risks that could affect profit or loss. In our view, this objective will result in entities properly presenting the effect that risk management activities have on their assets and liabilities. However, for reasons discussed below, we do not believe the ED will achieve this objective.

The proposal does not permit hedge accounting for core deposits, credit risk and equity instruments designated at fair value through other comprehensive income (OCI); as the Board's view was hedge accounting for these instruments cannot be achieved within the existing framework and introducing another framework would add complexity. However, entities' risk management strategy includes managing these risks. Failure to apply hedge accounting for these instruments would result in financial statements that are not indicative of the underlying economics or representative of entities' risk management strategies, and may create unwarranted volatilities in income. We believe the Board should address the hedging issue for these instruments if the objective of hedge accounting is to represent entities' risk management strategies. Notwithstanding the above, these aspects may potentially be addressed by the Board during its project on macro hedging as discussed in Appendix B.

### 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?**

Comments:

We agree with the proposal that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss ('FVTPL') should be eligible hedging instruments as including these instruments will provide greater flexibility for entities in selecting the hedging instrument that is most cost effective. However, it is not clear how this will reconcile with IFRS 9 requirements for designating an instrument as FVTPL as well as using it in a designated hedging relationship.

Also, the ED continues to prohibit the disaggregation of a non-derivative financial instrument into risk components other than foreign currency risk. In doing so, the Board has acknowledged that this will impact the likelihood of achieving hedge accounting for those instruments as the effects of other components not related to the hedged risk cannot be excluded from the hedging relationship and consequently, from effectiveness assessment. Therefore, we believe the Board should address and resolve the disaggregation of risk components for non-derivative instruments in this proposal in order to introduce a meaningful option for entities. Failure to do so will result in limited ability for entities to use these non-derivative financial assets or liabilities as hedging instruments since they are unlikely to qualify as effective hedges when impacts of other components are included in the assessment.

### 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?**

Comments:

We agree with the proposal that an entity may designate, as a hedged item, an aggregate exposure that is a combination of another exposure and a derivative. Financial institutions are often required to enter into

transactions that can result in multiple risk exposures and these exposures may be managed together or separately, similar to the situation discussed in B9(b) and BC50. We believe the Board should provide illustrative examples to assist entities in applying this new hedging concept which effectively would result in entities hedging a synthetic exposure. The Board should address the following questions on this synthetic exposure:

- Which combination of debt /derivative would qualify as a hedged item;
- What type of hedging relationship should be used (fair value and/or cash flow);
- What method of accounting would be applied to the synthetic instrument;
- Would this be accounted for with one or multiple hedge accounting designations;
- If the “hedged group” is able to be composed of both cash instruments and derivatives, how should the basis adjustments be calculated for the group given that some of the “hedged” items are already marked to market (i.e. putting a basis adjustment on a derivative results in a derivative that is no longer accounted for at fair value);
- What would the accounting be if only part of the aggregated exposure is derecognized (i.e. the hedged cash instrument component but not the hedged derivative component) and how is the associated basis adjustment accounted for;
- How will basis adjustments be accounted for in a dynamic book of hedged items in which some of the hedged items will be derecognized from time to time;
- How will the hedge effectiveness for a hedged item with multiple risk components be assessed and how will the amount of ineffectiveness to be recorded in the P&L be determined; and
- To what extent is there choice as to whether the derivative can be considered a hedged item versus a hedging instrument and to what extent would this choice drive a different accounting result?

#### 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?**

#### Comments:

We agree with the proposal that risk components that are separately identifiable and reliably measurable can be designated as hedged items. The proposal in the ED for financial instruments is consistent with the current standard and we support extending this flexibility to non-financial items, aligning the treatment of risk components for both financial and non-financial items such that all entities can properly reflect and report their risk managing strategies in their financial statements, regardless of the risk characteristics. However, we believe the Board should also address the following issues related to eligibility of a hedged item.

- The proposal maintains the existing restriction that the component of cash flows of a financial asset or financial liability designated as a hedged item must be less than or equal to the total cash flows of the asset or liability. We have provided an example in Appendix B to this document that demonstrates the rationale for entering into hedging relationships that involve sub-LIBOR assets or liabilities when managing risks on an overall balance sheet basis. We encourage the Board to re-consider the current prohibition on hedging the LIBOR component of sub-LIBOR instruments in its development of the macro hedging exposure draft.
- With respect to the credit risk component of a financial item, the Board’s current view is that it is difficult to isolate and cannot be measured reliably and thus, the use of credit derivatives to manage credit risk will generally fail to achieve hedge accounting. We believe it is possible to identify credit risk components for certain financial instruments such as ‘plain loans’ with no prepayment features or other options. For plain loans, entities can isolate and reliably measure the credit risk. Therefore, for scenarios where an entity can demonstrate its ability to separate and reliably measure the credit risk component of a financial item, the entity should be permitted to apply hedge accounting in managing the credit exposure. We agree with the Board that when the entity cannot demonstrate that the credit risk component can be isolated and reliably measured, hedge accounting should not be permitted.

#### **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?**

#### **Comments:**

- a) We support the Board's proposal that in addition to a percentage component of a nominal amount, an entity should be allowed to designate a layer component as the hedged item. Allowing the designation of a layer component will enable entities to better align financial reporting results with risk management strategies. We also encourage the Board to provide examples in the final standard to further clarify how hedge accounting is applied to a layer component to assist entities in applying this approach.
- b) The ability to hedge pre-payable assets (such as mortgages) is commonly used by banks as part of their risk management strategies. As a result, we do not agree with the proposal that a layer component of a contract that includes a prepayment option should be ineligible as a hedged item in a fair value hedge where this option's fair value is affected by changes in the hedged risk. Consistent with the proposed objective of hedge accounting, we encourage the Board to allow entities the ability to designate a layer component that incorporates prepayment optionality, insofar it is consistent with an entity's risk management strategy. In addition, we are concerned that even outside of a layering approach the ED (specifically paragraph B23) can be construed to mean that pre-payable assets are not eligible as hedged items in a qualifying hedging relationship despite the fact that these pre-payable assets are hedged items in hedge accounting relationships under current IFRS. Layering is not the only way to hedge pre-payable assets, whether the pre-payment impacts fair value fully or partially. Therefore, we encourage the Board to clarify that hedging strategies, such as where the full notional of pre-payable assets adjusted for rates of expected prepayment are being hedged, should continue to be permitted without using the layering approach.

#### **Question 6**

**Do you agree with the hedge effectiveness requirement as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirement should be?**

#### **Comments:**

We agree with the Board that an objective-based assessment would enhance the link between hedge accounting and an entity's risk management activities. We agree with the requirement in B28 that an entity should analyze the sources of ineffectiveness that are expected to affect the hedging relationship during its term, as this analysis is the basis for the entity's expectations of hedge ineffectiveness for the hedging relationship. We also support the removal of the 80% -125% bright-line test for hedge effectiveness, as this range is arbitrary and may not represent risk management objectives;. Entities have failed to qualify for hedge accounting simply due to the resulting percentage exceeding the range by a small amount. With respect to methods of assessing hedge effectiveness, we agree with the proposal that the method can be qualitative or quantitative, based on circumstances and facts.

However, we believe the Board should clarify certain aspects of hedge effectiveness assessment to facilitate application by entities. As indicated in B29, the objective of hedge effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and minimize hedge ineffectiveness. The proposed criteria could be interpreted as requiring a 'perfect' (not biased) hedge at inception and throughout the duration of a hedging relationship. This would disallow entities from over or under hedging at any point, even though this is part of their risk management strategy. We ask the Board to clarify that this is not its intent. We suggest the Board amend the proposed wording for hedge effectiveness and effectiveness testing so that the hedge effectiveness assessment and any ineffectiveness is compared to risk management policy and objectives and assess whether it is consistent with the entity's risk tolerance level over the term of the hedging relationship.

#### 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?**

#### Comments:

- a) We support the proposal to rebalance the hedging relationship as this allows entities to maintain the most efficient hedging relationship; however, we do not agree that this should be mandatory. We believe this should be an option as entities should have the choice to terminate the hedging relationship when it is no longer effective. We also ask the Board to provide additional clarification and guidance on how to apply the rebalancing concept.

Additionally, risk management objectives and hedge accounting results may diverge over time and this divergence may not be corrected by simply adjusting the hedge ratio (i.e. through mandatory rebalancing). To correct for this divergence, entities should have the option to voluntarily de-designate the hedging relationship. In our view, this would better align an entity's accounting results with its risk management objectives.

- b) We support the proposal to allow entities the option to proactively rebalance the hedging relationship. There are circumstances where components of the hedging relationship (hedging instrument or the hedged item) might be affected by market conditions but the changes are not significant enough to require a modification of risk management strategy, as in the case of an asset/swap strategy where the risk management objective is to hedge interest rate risk on a bond with an interest rate swap. It is possible that changes in market conditions will affect the effectiveness of the hedging relationship, potentially causing it to fail the effectiveness criteria in future periods. In this situation, proactive rebalancing activities (i.e. adjusting the hedge ratio) would be appropriate.

#### 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?**

#### Comments:

We disagree with the ED's proposal to allow entities to discontinue hedge accounting only where the hedging relationship ceases to meet the qualifying requirements.

The proposed rule creates unnecessary restrictions in the application of hedge accounting. Hedge accounting is a choice and as such, we encourage the Board to consider that an entity's risk management is not static but dynamic, with hedge accounting being only one aspect of our risk management activities. Within the constraints of the accounting framework, an entity may also be forced to create hedge accounting strategies that are not fully aligned to its risk management strategies. Management should have the flexibility to discontinue hedge accounting if it so chooses at any time, as a means to meet the changing needs of risk management objectives. When rebalancing the hedge relationship is not an optimal solution economically, the risk manager may decide to enter into a new hedge in order to conform to the dynamic risk management strategy. We therefore believe the risk manager should have the ability to voluntarily discontinue hedge accounting by simply revoking the designation of the hedging relationship

when it is aligned with its risk management strategies, and it should not be precluded from doing so due to an accounting restriction.

We believe the proposed standard will limit an entity's ability to freely de-designate a hedge relationship without terminating the derivative. When entities hedge pools of assets and liabilities, those pools constantly change due to the default and prepayment characteristics of products within the pools. Under these circumstances, the economic need for hedging the pool changes and creates the need to change hedge designations. Under the proposal, entities would no longer be permitted to voluntarily de-designate this hedge relationship without exiting the derivative in order to cease hedge accounting. It may not always be possible to terminate a derivative contract in these circumstances without incurring a financial penalty and would add unnecessary expenses by increasing transaction costs for entities that use dynamic hedging strategies. Instead of moving derivatives between portfolios, two sets of virtually offsetting transactions would be required, having a cost implication, while not changing the substance of how risk is being managed.

If the derivative is not terminated, then entities will incur additional costs to enter into transactions to offset the derivative position that cannot be de-designated. The prohibition on de-designating hedging relationships will not only severely affect the successful hedging of portfolios of homogenous assets/liabilities, but it will also lead to further divergence between the economic substance of an entity's risk management measures and its reported results. We propose that the Board amend the ED to allow for the voluntary de-designation of hedging relationships.

#### **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 recognized 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?**

#### **Comments:**

- a) We disagree with the proposal. We believe this proposal only changes the presentation of the items for fair value hedges without reducing the complexity relating to hedge accounting, and therefore, would not add significant incremental benefit to the users of financial statements. The proposed mechanics of recording the effective portion of both the hedging derivative and hedged item in OCI appears to be redundant given they will always be equal and offsetting as any ineffectiveness would be reported in profit or loss. This change would result in essentially identical accounting results as under current IAS 39 so the effort to implement the change is not warranted.
- b) We disagree 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 since these measurement adjustments are not separate assets and liabilities in their own right and these separate lines might be perceived by the users of financial statements to add complexity to hedge accounting instead of simplifying it. We believe that grouping an MCA with the hedged item on the statement of financial position provides users a better understanding of the profit and loss implications if the hedged item were to be derecognized. We recommend that this information be presented in the notes to the financial statements, separating the gain or loss on the hedged item from the carrying value of the hedged item.
- c) We agree that linked presentation should not be allowed given the offsetting exposures may be with different counterparties. However, using linked presentation in the notes would provide the readers meaningful information on how the overall exposure is being managed.

#### 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 capitalized 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?

#### Comments:

- a) We agree with the proposal to include the option's time value in OCI as it is a cost of hedging and the change will eliminate income volatility. However, as indicated in our response below, we disagree with the proposed mechanics on how to subsequently reclassify the amount to profit or loss.
- b) We do not support the use of 'aligned time value' even though it may be conceptually purer. As indicated in the examples provided by the IASB Staff, the determination of the amount to be included in OCI versus income is complex and susceptible to error, and explaining the mechanics to users of financial statements will be challenging.
- c) We do not support the use of 'aligned time value'. If the Board decides to differentiate between 'aligned' and 'actual' time values, we ask the Board to consider a simpler approach. Since time value for the aligned and actual options can be determined using an option valuation model, entities could determine the time value for both options at each reporting period and record the change in time value for the aligned option in OCI. Any difference in the amount of change in time value between the aligned option and the actual option should be recorded in income. While this approach will not differentiate the treatment between transaction-related versus period-related option (and thus will not amortize the time value for the period-related hedged item) as proposed in the ED, we believe this approach will reduce the complexity for implementation while still ensuring only the right amount of time value is captured in OCI.

Notwithstanding our proposal above, we request further clarification on the difference between transaction and time-based options and if the difference is predominantly based on whether the hedged item is currently recognized on balance sheet (a time-based option) vs. a forecasted transaction (a transaction-based option). In order to simplify the accounting requirements, we would recommend that the accounting treatment for both transaction and time-based options be treated in the same manner as both effectively represent a form of insurance premium for many risk management activities banks undertake. Please refer to Appendix B for a further explanation of this view as part of the suggestions for the Board's ongoing macro hedging project.

#### 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?**

#### Comments:

We generally agree with the proposed criteria for the eligibility of groups of items as a hedged item, which require the group to consist of items that are eligible hedged items on their own and are managed together on a group basis for risk management purposes. We support this approach as the requirements for qualifying hedge accounting for groups of items should be similar to individual hedged item. This proposal will also provide more flexibility to group items, allowing entities to identify the net exposure required to be hedged and better depicts risk management practices used by entities. We also agree that for cash flow



hedges, only items that impact profit or loss in the same reporting period should be grouped together as a hedged item for hedging of the net position.

#### **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?**

Comments:

We prefer the presentation of gains and losses from hedging activities on a gross basis in the income statement. Even though an entity may manage offsetting exposures on a net basis, each gross position has effectively been hedged. We believe that presenting the impact of the hedging practices on a gross basis leads to closer alignment with management's intention. For instance, an entity, and the users of its financial statements may evaluate the performance of products on a gross basis, after taking into consideration the impact of the entity's hedging activities. We understand the Board's reluctance to allow presentation of hedging gains/losses for items that seemingly do not exist, unless the positions themselves are hedged on a gross basis, but encourage the Board to weigh this up against the economic intent of entities when executing hedges that involve offsetting risk positions.

#### **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?**

Comments:

We generally agree with the proposed disclosures as they will result in more prominent and transparent presentation of the effects of hedge accounting on the financial statements. However, we have concerns with the amount of information required to comply with the requirements, particularly those related to future cash flows. Although the IASB Staff has provided illustrative examples to assist in assessing these requirements, the examples reflect hedging the risk exposure for a single financial item group (interest rate risk for loans payable, and foreign exchange risk for assets), and are generally not reflective of the complex risk management strategies undertaken by financial institutions.

The Board should also clarify the disclosure requirement in paragraph 51(b) relating to fair value hedges. As is currently written, it is unclear whether the disclosure on the change in the value of the hedged item under this paragraph is the same amount as the adjustments made to the hedged items that are required to be presented as a separate line item to the hedged assets or liabilities in the statement of financial position under 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?**

Comments:

We support this proposal to allow a commodity contract which can be settled net and is entered into for the purpose of receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements, to be accounted for as a derivative in appropriate circumstances. We agree with the Board that this approach better reflects the contract's effect on the entity's financial performance and provides more useful information.

#### **Question 15**

- a) **Do you agree that all of the three alternative accounting treatment (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?**

#### **Comments:**

- a) We do not agree that all of the three alternative accounting treatments considered by the Board to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments. As indicated in our response to 15(b) below, we support the approach of alternative 3 discussed in BC 226(c), as it aligns with the credit risk management strategies of financial institutions and provides a reasonable proxy for hedge accounting when an entity could not isolate the credit risk. However, an entity should be permitted to apply hedge accounting for credit risk when it can isolate and reliably measure the credit risk, as discussed in our comments to Question 4.
- b) We ask the Board to consider alternative 3 to account for the relationship when hedge accounting could not be applied; however, we agree with the Board that alternative 3 is complex. As illustrated in the example provided in the Staff's paper (Staff paper 21B for IASB's meeting on the week of October 18, 2010), MCA related to loans would be amortized to income over the term of the loans while MCA related to loan commitments would not be amortized but would be recognized in income in its entirety. We do not support this proposal as we do not believe it is operationally feasible to have a different treatment for MCA for loans versus loan commitments. In our view, the treatment for MCA should be consistent and MCA related to loan commitments should be amortized over the expected term of the resulting loan when there is reasonable expectation that a loan will result, otherwise over the loan commitment period. If entities are not allowed to amortize MCA related to loan commitments, then we would prefer alternative 2 which requires MCAs to be recognized immediately in income.

Managing credit risk is an important component in the risk management strategies of all financial institutions. In addition to our above responses to Question 15, we also suggest that the Board set up a working group to solicit views from valuation experts and risk management practitioners on the practicality of applying alternative 3 and isolating the credit risk component of loans structures that range from simple to complex in hedging credit risk. The Board should take into consideration these views in finalizing a hedging standard that reflects the risk management activities of entities and can be practically applied.

#### **Question 16**

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

#### **Comments:**

We agree with the proposal that the new hedge accounting requirements be applicable prospectively, with no restatement of comparative figures or requirement to give the disclosures for the comparative period. We also support the Board's decision to consider the feedback on the consultation paper on effective dates for new standards - please refer to the CBA's response letter dated January 31, 2011. The complexity of change in the proposed ED and its interaction with macro hedging which has yet to be released will require significant lead time in assessing how we will approach hedge accounting and the related systems impacts that will occur as a result.

### Key topics to consider for macro hedging project:

We encourage the Board to consider the following aspects during the next phase of its hedge accounting project that will cover off macro hedging.

#### 1. Risk Management Objective

In addition to our response to question 1 in Appendix A, we believe that entities should be able to account for their risks in a manner that is consistent with their risk management practices. Hence, the macro hedge accounting model should take into account risk management practices applied by preparers of financial statements, in particular banking institutions.

One of the objectives in developing the current hedging ED is to reduce complexity in hedge accounting. The inherent nature of an entity's macro hedging practices is complex. In order to develop a robust macro hedging model that addresses key macro hedging concepts that are prevalent in the banking industry, sophistication and complexity are inherent necessities that must be built into the model. Many organizations have already addressed the complexity of these inherent risks, and techniques to measure and manage these risks. In order to arrive at a practical and simplified approach, the Board should allow for increased reliance on existing risk management systems and practices.

#### 2. Appropriateness of Current Hedging Concepts

There are concepts and rules prescribed by the current hedge accounting model that are relevant for individual hedges but are not necessarily suited for macro hedges. These concepts should be addressed in the macro hedging model and are as follows:

##### Hedged item

- The ability to use core deposits in macro hedging relationships  
If hedge accounting principles are to be aligned with actual risk management strategies, core deposits, or other products that are demand-based or that have no contractual maturity, should qualify as eligible hedged items. For instance, core deposits are payable on demand even though practically there is a base level of deposits that will always be available, either because the deposit has a long expected life (e.g. savings account) or the shorter-life deposits are replenished continuously. Banks view these as stable fixed/zero rate long term funding sources in managing their balance sheet risk.

In the basis for conclusion to IAS 39, the Board indicated that *deposit liabilities are unlikely to be outstanding for an extended period. Rather, these deposits are usually expected to be withdrawn within a short time (eg a few months or less), although they may be replaced by new deposits (IAS 39 BC 187(a)).* We feel that this is not always the case, as different types of core deposits drive different behaviours. For instance, for certain organizations savings accounts may be stable in nature and generally be outstanding for an extended period, while funds in chequing accounts may be more subject to withdrawals and replacement.

In IAS 39 BC 187(d), the Board states that *the fair value is unaffected by interest rates and does not change with interest rate moves. Accordingly, the demand deposit cannot be included in a fair value hedge of interest rate risk – there is no fair value exposure to hedge.* From a risk management perspective, an entity's objective is to lock in a margin between its funding sources (e.g. deposits) and loans, and not to fall into an accounting category such as fair value hedge accounting. As such, to fully align risk management with accounting, the macro hedging model should recognize this and include core deposits as eligible hedged items in hedge accounting relationships.

The requirement to define a hedged exposure based on contractual terms rather than expected terms leads to a misalignment with risk management practices and is not consistent with current accounting literature, where in many instances the economic substance of a transaction drives the accounting, rather than contractual terms. For example, the effective interest rate method (EIRM) is based on the expected life of a financial instrument and not its contractual life. Also, it does not seem consistent to be required to use expected life to calculate the EIRM for an existing financial instrument with known terms, while core deposits, acting as hedged items, has to be based on contractual terms when used to protect future margins.

- Identification of hedged item through layers  
An entity's risk management objective may be to designate in different time periods the net exposure in a macro hedge. Within the context of determining layers in accordance with the ED, the macro hedging model should address how the layers are to be determined for prepayable assets. Without the ability to hedge a layer that contains a prepayment option, an organization may have no practical means to manage their prepayment risk and account for it in a manner consistent with their risk management practices.

#### Hedged risk

- Hedging the sub-LIBOR component within assets/liabilities  
We encourage the Board to evaluate this issue from a macro hedging perspective as described in our answer to question 4 in Appendix A of this letter.

To understand why hedging of sub-LIBOR components should be allowed, it is useful to look at the issue from both an asset and liability perspective. This will illustrate the entity's risk management objective of earning a stable margin on its investments utilizing its funding sources. Consider the following example:

From a balance sheet management perspective, an organization may have core deposits. These deposits may be relatively insensitive to interest rate changes, and are commonly managed as if they have terms exceeding their re-pricing date, and assigned a rate akin to a fixed rate (acknowledging the insensitivity to departure from the current rate). In this example we have assigned a fixed rate of 4% to the deposits.

In turn, this source of funding may lead to interest rate risk where an organization invests in floating rate assets, including short term fixed rate instruments such as commercial paper that is continuously rolled over. We have assumed these investments earn a return of LIBOR – 20 bps.

This will result in an interest rate mismatch between the investments and deposits, exposing the organization to interest rate risk. To manage its risk, the organization enters into a receive fixed, pay variable swap with the current swap rate of 5%.

From an economic standpoint the following result has been obtained:

<b>Instrument</b>	<b>Fixed rate</b>
Deposit	(4%)
Asset	Libor – 20 bps
Swap – receive leg	5%
Swap – pay leg	(Libor)
<b>Net result</b>	<b>80 bps margin</b>

From an accounting perspective, the swap can not be designated as a fair value hedge using the deposit as an entire benchmark rate hedge for 2 reasons:

(i) The economic hedged item can not be carried over to the accounting hedged item in terms of economically inferred terms (rate and duration); and (ii) The assigned rate would be considered sub-LIBOR.

Similarly, the swap cannot be considered in a cash flow hedge of the assets, as the cash flows produced from the assets are considered sub-LIBOR.

This is in contradiction to the fact that the organization has locked in a positive margin through its risk management activities.

### **3. Pre-payable assets/liabilities**

In addition to considering the benchmark rate component of prepayment options to be an eligible risk, we also encourage the Board to consider the current accounting implications when hedging prepayment risk, and misalignment thereof with risk management practices.

For example, a bank issues redeemable deposit certificates (RDCs) to its customers and uses the proceeds to invest in fixed rate assets. The bank's risk management objective is to manage a stable margin between the interest income earned on the assets and the interest expense paid on the RDC. To hedge against declining margins in the event that a client redeems their deposit, the bank purchases a swaption with exercise dates and terms matching the ones of the customer options. Under a fair value hedge, if rates do not increase and the customer does not exercise the redemption option, the risk management objectives match the accounting for the hedge. However, if rates increase and the customer exercises the redemption option, a mismatch between accounting and the economics of the transaction will occur. Any basis associated with the hedge must be recognized in income immediately, even though it had to serve as a future decrease in interest expense to maintain a stable margin.

Difficulties in meeting the "highly probable" threshold for cash flow hedges makes the use of a strategy that would lock in future interest expenses virtually impossible. When considering the macro hedging model we would encourage the Board to consider this issue, and potentially allow some flexibility in meeting the highly probable threshold where the economic risk is apparent, it needs to be hedged, and a suitable accounting solution is not available.

Options and prepayment:

The recognition of costs incurred for hedging prepayment through a swaption in the scenario above would be most reasonable if spread over the term margin protection is achieved, rather than over the life of the option. In this case, forming an accounting designation through a fair value hedge should not arrive at a different accounting for the recognition of the option's cost, as the risk management practice is identical in both instances. Therefore, we encourage the Board to consider similar treatment for time and transaction based option costs.