



Instituto Iberoamericano  
de Mercados de Valores

Santiago Cuadra  
Secretario General

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom  
Email: [commentletters@iasb.org](mailto:commentletters@iasb.org)

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

Dear Sirs,

*Instituto Iberoamericano de Mercados de Valores (IIMV)* is pleased to respond to the International Accounting Standards Board's (the IASB's) *Exposure Draft ED/2010/13 Hedge Accounting* (referred to as the 'exposure draft' or 'ED').

IIMV is an organization formed by securities regulators from the Ibero-american area that is committed to the development of the transparency and integrity of the securities markets, improve the knowledge of their structure and regulation, enhance the harmonization and encourage the cooperation between supervisors and regulators. Attached list of members of IIMV.

IIMV members acknowledges the efforts made by the Board to improve the existing hedge accounting requirements, making them more easy to understand, apply and enforce. In that sense we support the direction taken by the Board in the ED, we have some concerns on how some requirements will work on practice, which are further explained in our answers included in the Annex to this letter.

In that sense, we have suggested, in relation with some improvements in addition to the proposed requirements, the inclusion in the ED of additional guidance or illustrative examples to clarify several issues. Nevertheless, our main source of concerns is related to the disclosures. We are of the opinion that a robust disclosure structure in hedging plays a very important role in the fulfilment of the objective set up in the standard. In consequence, we are proposing enhanced disclosures to be included in the ED, not only applicable for hedge accounting structures but even if economic hedging is used and hedge accounting is not applied by the entity, which we think it is also very relevant for a comprehensive understanding of the entity's risk management in relation to the financial instruments.

Our detailed comments and answers to your questions on the exposure draft along with other comments are included in the Appendix to this letter.

We are pleased of your consideration on the comments included in this letter. If you have any questions concerning them, please contact the Secretary General in Madrid, by email [acf@iimv.org](mailto:acf@iimv.org) or at phone +(34) 91 585 09 01.

Yours sincerely,

Santiago Cuadra

Instituto Iberoamericano de Mercados de Valores  
C/ Miguel Ángel 11, 4ª Planta, 28010 Madrid- España  
Tel: + (34) 91 585 09 01 Fax: + (34) 91 585 16 41; [www.iimv.org](http://www.iimv.org)

## **INSTITUTO IBEROAMERICANO DE MERCADOS DE VALORES (IIMV)**

The Council of IIMV is comprised of the maximum authorities of the securities market supervisory bodies in Ibero-american countries and a senior representative of the public administration with regulatory responsibilities for capital market affairs. The Council is chaired by the Chairman of the Comisión Nacional Supervisora de Empresas y Valores (CONASEV) de Perú

The current membership are:

- Comisión Nacional de Valores de Argentina
- Comissão de Valores Mobiliários de Brasil
- Autoridad de Supervisión del Sistema Financiero (ASFI) de Bolivia
- Superintendencia de Valores y Seguros de Chile
- Superintendencia Financiera de Colombia
- Superintendencia General de Valores de Costa Rica
- Superintendencia de Compañías de Ecuador
- Comisión Nacional de Valores de España
- Secretaría de Estado de Economía de España
- Superintendencia de Valores de El Salvador
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- Comissão do Mercado de Valores Mobiliários de Portugal
- Secretária de Estado do Tesouro e das Finanças de Portugal
- Superintendencia de Valores de República Dominicana
- Banco Central de Uruguay
- Comisión Nacional de Valores de Venezuela

## APPENDIX

### Responses to questions ED/2010/13 Hedge Accounting

#### **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?

#### **Response**

We think the IASB's description of the objective is clear. IIMV members agree on the inclusion of an objective for hedge accounting, as it helps to a better understanding of the principles-based standard. This is a very useful tool that can help the practical application of the standard which by definition, cannot capture all possible scenarios.

Having said that, we would like to remark that when hedge accounting is applied, some types of hedging activities, that are part of the entity's risk management activities may fall outside the scope of the standard. In consequence, if the objective is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments, there may be some risk management activities with financial activities outside the scope of the standard and in consequence users of financial information will not have the entire picture of those activities. A solution, although not preferred by us, would be to limit the objective to those activities under the scope of the standard; the IIMV members would prefer a solution of incorporating to the standard all types of hedging relationships, not just accounting but also economic ones, so that users of financial information have all the information relevant to decision-making. In the case of economic hedging, as well as for those relationships that meet the requirements to apply hedge accounting but for which the entity voluntarily decided not to apply it, the IIMV proposes to meet the objective stated at the beginning of the standard through adequate disclosure requirements (see section on disclosures).

#### **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?

#### **Response**

We agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments. As they are currently used as hedging instruments, this would be consistent with the standard objective of to represent the effect of an entity's risk management activities.

Nevertheless we are not sure about what exactly types of non-derivative financial instruments would qualify as hedge accounting, as the ED indicates in BC 36 that *the disaggregation into components of a non-derivative financial instruments into risk components, other than foreign currency risk, [...] in most scenarios will not achieve other than accidental offsetting and therefore will fail the qualifying criteria.* By this reasoning it is supposed that the IASB does not expect a significant use of non-derivatives financial instruments as hedging instruments for risks other than foreign currency risk. In consequence, we encourage de Board to clarify and provide some examples of which types of hedging involving non-derivative financial instruments would qualify for hedge accounting.

### **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?

### **Response**

IIMV members agree that the aggregated exposures as those described in the ED may be designated as a hedged item. We are convinced by the reasoning provided in BC48-BC51 for doing so, as it would achieve the proposed objective for the hedge accounting.

We also think that the designation of an aggregated exposure as a hedged item may introduce an increased complexity. In consequence, we encourage the Board to introduce additional guidance on the issue to ease an adequate practical application and also to prevent non-desirable inconsistencies with both the hedging accounting or other standards.

### **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?

### **Response**

We support to allow to designate a specific risk or risks as a hedged item for both financial and non-financial items, as this also reflects entities' risk management activities. But we are of the opinion that the implementation of the two conditions required for the risk component/s to qualify as a hedged item could cause some implementation inconsistencies, i.e. a lack of comparability.

To enhance comparability we encourage the Board to clarify the principle underlying to distinguish which risk components qualify as being *separately identifiable and reliably measurable*. In this sense, an additional guidance would be welcomed.

On the first one, and in relation to the examples provided in the ED, we cannot understand why some risk components meet the *identifiable* criteria while others do not. We encourage the Board to better articulate its reasoning for clearly distinguishing when risk components fulfill the *reliable measurable* criteria and when not, and in particular to clarify if the interdependence issue between a risk component and other risks qualifies as a relevant fact. In particular, we do not understand why the Board explicitly prohibits in B18 the designation of the inflation as a risk component unless it is contractually specified, based on the fact that it is not separately identifiable and reliably measurable. Although we agree that generally this risk component will fail to comply the mentioned criteria, we would prefer have included a number of examples of when the criteria is or is not met instead of inserting an overall prohibition in a principle based standard. As mentioned before, an additional comprehensive guidance will better face the issue.

In relation to the reliability criterion for all hedged items, we encourage the Board to provide further clarification on it, especially in the light of the new fair value hierarchy criteria set up recently, and in particular with regards to the criteria fulfillment, or not, in the case of Level 3 measures.

Finally, we do not understand why the Board has concluded to prohibit the designation of a risk component of financial instruments as hedging instruments while it has been allowed for hedged relationships. The reason is that *such an approach would be a significant expansion of the scope of the hedge accounting project*. The same reason is applied by the Board for non-financial items. Nevertheless, as it has been recognized by the Board in BC33, permitting that would allow to entities to *show more accurately the results of its risk management activities*. In consequence, and in order to better the objective set up in paragraph 1 of the ED, we encourage the Board to further explore ways to allow component risks of financial instruments to be designated also as hedging instruments, as it occurs in the current practice and invite it to develop robust requirements that should be met to qualify for hedge accounting, including as a minimum that the hedging components should be separately identifiable and reliably measurable.

#### **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?

## Response

IIMV members agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item, as there are circumstances in practice when it is appropriate doing so.

In relation to the prepayment option, the decision the Board has taken seems to imply that the prepayment risk is not separately identifiable nor reliably measurable in order to meet the qualifying criteria. We are of the opinion that the Board should further explain its reasoning on the issue, as we think that in some situations prepayment risks are observable in the market (i.e. for financial instruments that are traded). Lastly, the fact that the option's fair value is affected by changes in the hedged risk seems to imply that the lack of interdependence is required to meet the criteria. In this regards it is not clear if that prohibits to designate as a layer the hedged nominal item as a whole, if the contract includes a prepayment option so that the option's fair value is affected by changes in the hedged risk. As indicated in Q4, we encourage the Board to provide a clarification on the interdependence issue.

### **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?

## Response

Yes, we agree with the proposed hedge effectiveness requirements as a qualifying criterion for hedge accounting, as it is more in line with a principle-based approach. We also agree with the removal of the 80-125% range of the current IAS 39 for the same reason. In relation to the removal of the retrospective test of the current IAS 39, we are of the opinion that the requirement of a *rebalance* is a good approach, that is also in line with how the entity manages its financial risks.

However IIMV members have concerns in relation to the practical application of the effective requirements that could lead to a diversity in practice of them. There are several elements of the qualifying criteria that are new for all stakeholders, on which a robust guidance on application would be desirable: these concepts are the unbiased result, minimize ineffectiveness and other than accidental offsetting. In that sense, a more broad range of examples that cover situations in the *border line* that comply or not with the effectiveness requirement would be desirable.

For that reason we encourage the Board to provide additional guidance on these issues to minimize undesirable effects by the ED and the risk of divergent application.

Lastly, IIMV members are of the opinion that it should be included a requirement to document and disclose in the financial statements, as part of the qualifying criteria, the criteria set up by the entity to consider when the ineffectiveness is considered being minimized and unbiased. By doing so users it will constitute a significant improvement for consistent application (as the criteria will be set up and disclosed



at inception), and also users of financial information will have relevant information for decision making.

### **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?

### **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?

## **Response**

IIMV members agree that if the objective of the hedge effectiveness assessment fails to be met, the entity should be required to rebalance the hedging relationship. The *rebalance* concept is new and guidance has been included in the ED, but we are of the opinion that to prevent a divergent application, some illustrative examples could be added to the ED.

In relation to the effectiveness assessment, we are concerned that without a robust management strategy, the management could arbitrage between the rebalance and the discontinuation. For that reason we encourage the Board to require for hedge accounting a documented risk management strategy for rebalancing, including the disclosure of the facts and circumstances that could lead the management change the risk strategy in the future, and also differentiating when the strategy should be rebalanced rather than discontinued. If a hedging relationship has been discontinued, the entity should disclose it and put the decision in its risk strategy's context. This requirement would also include the disclosure of the policy followed by the entity to carry out the hedge effectiveness assessment indicated on the ED.

IIMV members also agree that the entity can proactively rebalance the hedging relationship if it expects that will fail the effectiveness relationship, as it is consistent with how entities manage these risks. However we have also concerns on the divergent application, so for that reason we encourage the Board to consider

including a requirement to disclose the strategy followed and impact caused by the proactive rebalancing.

We also are of the opinion 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 and 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, as it is in line with the objective indicated in the ED.

#### **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?

#### **Response**

IIMV agrees 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. However IIMV members would like the Board to include the distinction between items to be included in OCI versus in profit or loss in relation to the entity's performance to be finally dealt with in a separate project.

We also 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. However, to avoid multiple lines to be included in the balance sheet, we would prefer a requirement to disclose only one line for the assets' hedge accounting side and other for the liabilities one, disclosing the disaggregated amounts on the notes. These disclosures should be clearly enough in order a reader of the financial information to understand each gain or loss associated with the hedged items.

The requirement that linked presentation should not be allowed for fair value hedges is fine with us.



**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?

**Response**

IIMV members agrees with the solution proposed by the Board as it better reflects the substance of the transaction and is more in line with how the entity manages financial risks, as opposed with the current requirements set up in IAS 39. We think that the benefits for this solution outreaches the inevitable cost increase of performing it.

**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?

**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?

**Response**

We support the proposed criteria for the eligibility of groups of items as a hedged item, as it is line with the entity's risk management activities that use financial instruments.

However, we have some concerns on the distinction between the concept of group of items and the macro-hedging, which is not under the scope of this ED and will be

dealt with in a future project. We are of the opinion that a further clarification on the issue will be desirable. Lastly, as far as the macro-hedging project has not taken on board yet, it is unknown their interaction and whether the requirements proposed in this ED will be affected or not.

Lastly, we agree that 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 for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement.

#### **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?

#### **Response**

IIMV members also believe that the proposed disclosures provide relevant information that enhances the transparency regarding an entity's hedging activities, as it provides information about the entity's risk management strategy, how it affects the future cash flows, the statement of financial position, statement of comprehensive income and statement of changes in equity.

However, we think that the disclosures requirements could be improved to allow the user of the financial information to achieve a better level of understanding of how the entities has set up and manages the risk activities in relation to the financial instruments. In that sense, we have proposed some additional disclosure requirements that have being explained though the answers to the different questions.

#### **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?

#### **Response**

We support the proposed change in these types of contracts to buy or sell non-financial items as it solves practical problems that have lead to accounting mismatches when the entity tried to cover the exposures arising in these situations.

**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?

**Response**

Although financial institutions manage credit risk using credit derivatives, we agree with the Board in not proposing an alternative accounting treatment to account for hedges of credit risk using credit derivatives, based on the fact that it is operationally difficult, if not impossible, to isolate and measure the credit risk component of a financial item as a component that meets the eligibility criteria for hedged items. Nevertheless and having said that, we would like the Board to produce a more articulated explanation in relation to the linkage with the requirements currently in place in IFRS 7 in relation to the separate disclosure of the measurement of changes due to the own credit risk.

**Question 16**

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

**Response**

Although IIMV members usually prefer a retrospective application, prospective application is a more balanced solution as it will avoid unnecessary costs for the entities, especially for long term hedges.

In relation to the transition period, we are not in favour of permitting an early application due to the fact that the long transition period could affect the comparability of the financial information.