



IASB
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

15 March 2011

Dear Sir or Madam,

RE: EXPOSURE DRAFT HEDGE ACCOUNTING

BUSINESSEUROPE welcomes the opportunity to respond to the exposure draft on Hedge Accounting (the ED). We would also like to thank the Board for its outreach activities in this area, which we were able to take advantage of in February.

We acknowledge and greatly appreciate the efforts the Board has made in order to modify hedge accounting so that it better reflects the risk management model of the entity.¹ In our view, this is the right principle upon which to base the hedging standard. We believe that this will not only help the management of the entity to understand better the effect of its risk management activities on the financial statements of the entity, but that it will also greatly facilitate the communication about risk management between the management and the users of the financial statements. As an example, the elimination of the 80-125% effectiveness corridor, the possibility to designate components of non-financial positions as hedged items and the proposal to recognise the time value of options designated as hedging instruments can be considered great improvements. These and other proposed modifications should be advantageous to all stakeholders.

Inevitably there are areas which we think could be improved from the proposals of the ED, but we would not like our comments on these matters to hide the fact that the ED represents a good basis to start from to achieve a high-quality standard, and the suggestions we have are for improvements at the margin.

Please find attached our detailed comments. Our main concerns can be summarised as follows:

- Although we welcome the introduction of the concept of 'rebalancing', we urge the IASB to redeliberate on this concept, because we believe that the concerning proposals are not precise enough to allow preparers to apply them consistently. Therefore, we propose leaving the decision to rebalance solely with preparers in accordance with their risk management. Otherwise rebalancing will potentially

¹ The Spanish federation CEOE however believes that part of the complexity in hedge accounting is caused by the requirement to account for all derivatives at fair value, including those held for hedging purposes to maturity. Their concerns are set out in their comment letter.



generate a lot of costs due to maintaining hedge accounting systems and preparing hedge documentations.

- Furthermore, in our opinion the proposed disclosure requirements are one of the most crucial points of the ED. Most notably, this is true for the proposals on disclosing 'the amount, timing and uncertainty of future cash flows' as outlined in paragraphs 45 et seqq. of the ED because that would imply presenting highly sensitive information, particularly estimations about amounts and quantities being hedged in the future and the corresponding hedge ratios. Thus, the proposed disclosure requirements are not acceptable for us.
- Regarding the application of fair value accounting on "own use" contracts, we think that the issue is not adequately solved and requires that the following should be considered:
 - o derivative accounting should be allowed as an option only ; and
 - o it should be considered that contracts may be composed of two or more separate contracts for the purpose of IFRS 9 under certain conditions.
- In a principle-based model there should be no rule excluding specific risk components from hedge accounting: the entity must document its strategy and clearly justify its methods. Therefore, the Board should not prejudge and exclude:
 - o sub-LIBOR hedging;
 - o credit risk hedging;
 - o hedging of non-contractual inflation indices;
 - o hedging of items which do not affect profit or loss; and
 - o written options as hedging instruments².
- We reserve final judgement on the general model for hedge accounting until the macro-hedging model is published in its entirety.

Yours sincerely,

Jérôme P. Chauvin
Director
Legal Affairs Department
Internal Market Department

² We specifically refer to the IEAF (International Energy Accounting Forum) specific comment letter.



APPENDIX I - RESPONSES TO THE SPECIFIC QUESTIONS

OBJECTIVE OF 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?

Basically, we do agree with the proposed objective. We agree that under a principle-based approach this definition is very important. We also appreciate that the IASB has decided to leave hedge accounting furthermore an accounting choice.

However, we question the restriction within the proposed hedge accounting objective as outlined in paragraph 1 that all designated exposures within hedge accounting are restricted to those 'that could affect profit or loss'. We ask the IASB to redeliberate on prohibiting instruments not accounted for as at fair value through profit or loss from hedge accounting, as there could be circumstances where an entity might want to designate equity instruments measured at fair value through other comprehensive income as hedged items.

INSTRUMENTS THAT QUALIFY FOR DESIGNATION AS HEDGING INSTRUMENTS

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 do agree with the proposal. This will allow a closer alignment between hedge accounting and entity's risk management activities.

DERIVATIVES THAT QUALIFY FOR DESIGNATION AS HEDGED ITEMS

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 do agree.

We think it would be helpful if the Board were to consider the following two common examples of what we think are eligible hedged items as defined in the ED. If the Board confirms our interpretation, then perhaps it would include them in the final standard as illustrative examples.

Example 1

A company has issued a fixed-rate debt in foreign currency with a tenor of 10 years. The risk management approach is:

- Entering into a 3 months cross-currency interest rate swap, to transform it from fixed-rate debt in foreign currency into a floating-rate debt in local currency. This CCIRS will be rolled-over every 3 months
- Entering into a 10 years interest rate swap, to transform it from floating-rate debt in local currency into fixed-rate debt in local currency.

The eligible item will be the combination of:

- 10 years floating debt in foreign currency; and
- a 3 months CCIRS rolled-over each 3 months

Example 2

A company has issued a fixed-rate bond with a tenor of 10 years.

The risk management approach is to achieve certain balance of fixed and variable debt as defined in the strategy.

At inception a fair value hedge is designated for the bond, as a consequence, the company enters into a swap to convert the bond to floating rate, in order to cover the 'price risk' of the bond.

In the next period, as a result of a review of its strategy, the management no longer pursues the objective determined at inception ('price risk'), and hedge accounting is discontinued. At this moment, the new objective is not to be exposed to changes in the interest rates; as a consequence, the bond and the swap are designated together as the eligible items in order to convert the floating-rate bond (fixed-rate bond + swap) to fixed-rate debt again.

DESIGNATION OF RISK COMPONENTS AS HEDGED ITEMS

Question 4 - Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We do agree that risk components should be allowed to be designated as hedged items, as this will better reflect the economic reality of many transactions, in contrast to what is the case today under IAS 39.

However, we do not agree with the specific rule of the exclusion of inflation as an eligible item as stated in paragraph B18 of the ED. Therefore, we recommend deleting paragraph B18 on the final version of the standard.

We also do not agree with the rule that an entity cannot designate a component where the cash flows (CFs) are more than the total CFs of the hedged item. An example is currently the IAS 39 issue of debt at a sub-LIBOR rate. This results in certain entities with credit ratings of very high quality having more ineffectiveness (and therefore volatility) in the income statement than an entity that has a worse credit rating (since the latter can designate the LIBOR component whereas an entity with a good credit

rating must hedge the entire cash flows of the debt). This counter-intuitive result should be resolved in the new standard.

DESIGNATION OF A LAYER COMPONENT OF THE NOMINAL AMOUNT

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?

We do agree with the proposal, as this reflects one way that entities actually manage risk.

Question 5 (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 do agree in the case of an individual transaction. However we think that it is important that this decision should not preclude an entity from achieving hedge accounting for a layer component in a portfolio or macro hedge. We think that financial institutions in particular are able to identify layers reliably to achieve an effective hedge on the basis of "the law of large numbers".

HEDGE EFFECTIVENESS REQUIREMENTS TO QUALIFY FOR HEDGE ACCOUNTING

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 IASB's proposal to abolish the 80 to 125 per cent "bright-line" test for effectiveness testing as well as the obligation to carry out quantitative retrospective hedge effectiveness testing.

REBALANCING OF A 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?

Basically, we agree with the IASB's decision to introduce the concept of rebalancing, but we have concerns regarding the operationalisation of this concept as proposed in the ED.



In our view, the suggested provisions lack sufficient preciseness to be operable enough to be consistently applied in practice. Paragraphs B50-B52 try to operationalise when an entity should rebalance designated hedging relationships within hedge accounting with the help of a diffuse principle saying any rebalancing is necessary when 'changes in the extent of offset indicate that the fluctuation is around a hedge ratio that is different from the hedge ratio currently used for that hedging relationship, or that there is a trend leading away from that hedge ratio' and is not necessary when there are 'fluctuation around a constant hedge ratio'. Especially when there are hedging relationships that will last over a considerable time period it is almost impossible to predict, if 'there is a trend leading away from the hedge ratio' that is currently applied within a certain designated hedging relationship.

Therefore, we urge the IASB to redeliberate on the notion of rebalancing. We propose that entities should be able to decide based on their risk management strategy for each hedging relationship when rebalancing should be necessary because we believe that the proposed provisions on rebalancing could result in new complexity and significant costs in applying hedge accounting. To make rebalancing an entity's accounting choice based on its risk management, this would be also consistent with the overall objective to align hedge accounting with risk management more closely.

Moreover, this is an area which will be closely scrutinised by auditors and so the principle must be clearly stated in the final standard.

Question 7 (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 do not agree, should the proposed concept of rebalancing remain unchanged. See also our answer to question 7(a) above.

DISCONTINUING HEDGE ACCOUNTING

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?

We do not view the ability to de-designate hedging relationships to be problematic or an area of abuse under the current model. Hedge accounting by its nature is elective and, therefore, the ability to discontinue it is consistent with this notion.

The objective of dynamic hedging strategies is to promote effective risk management by ensuring the hedging relationship contemplates the changing economic conditions of the hedged item.

Additionally, the proposal is unclear as to whether net investment hedges are affected by the elimination of voluntary de-designations. Due to the nature of the underlying, net investment hedges often involve strategies that include de-designation and re-designation of both derivative and non-derivative instruments. Accordingly, we believe the final standard should specifically exclude net investment hedges from the prohibition against de-designation/re-designation strategies. But we need to read the 'open portfolio' model to understand how it works for this issue.

Question 8 (b) -Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

Please, see our answer to Question 8 (a).

ACCOUNTING FOR FAIR VALUE HEDGES

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?

No we do not agree. We question that the proposed fair value hedge mechanics will produce any additional value compared to the current mechanics according to IAS 39.

We believe that this proposal will only introduce additional complexity for preparers, which would be required to adjust hedge accounting systems to reorganise the recognition of hedging gains and losses for all fair value hedges.

Thus, we urge the IASB to retain the current mechanics for fair value hedge accounting in IAS 39 unadjusted.

Question 9 (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?

While we understand the concerns expressed that the current approach results in a mixed valuation model for the same item in the financial statements, we are concerned that when an entity uses fair value hedging for a large number of asset and liability categories in the balance sheet, the resulting multiplication of line-items could be detrimental to the clarity of the financial statements. We would recommend that the entity be allowed to use its judgement as to whether to make this disaggregation on the face of the balance sheet or in the notes. In either case, disclosure of the detail must be obligatory. We believe that it is management's responsibility to ensure that the financial statements are clear and complete.

Question 9 (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 agree that linked presentation should not be allowed for fair value hedges.

ACCOUNTING FOR THE TIME VALUE OF OPTIONS FOR CASH FLOW AND 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 (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?

Question 10 (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?

Question 10 (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?

We welcome the proposal to record the changes in time value of an option to other comprehensive income (OCI) (when it is excluded from the hedge relationship) rather than recognising them immediately in profit or loss.

However, a more simplified approach would be to amortise the original time value portion of the premium paid to profit or loss over the life of the option with subsequent changes in time value being accumulated to OCI. This would be an improvement over the current standard while not creating additional complexities. Our concern is that the current proposals are complex, in particular, the proposal to calculate a hypothetical option (when the critical terms do not match the exposure) in order to determine what portion of the time value is hedging and what portion has to be recognised immediately in profit or loss. This would add too much complexity from an operational standpoint. In fact, such a proposal is likely to result in entities changing their risk management strategy to use different derivatives, for example, a forward, so that they avoid the accounting/administrative burden created by the proposals of 10 (c). In addition, we believe the Board should also consider whether this treatment could also be applied to a forward contract.

HEDGES OF A GROUP OF ITEMS

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 would like to review the open portfolio proposal, before answering this question.

We are, however, concerned about the arguments used to disallow hedge accounting for a net position in which the hedged items affect profit or loss in different periods are not robust enough. Among others, we point out BC169-173 explaining that allowing hedge accounting – and therefore deferring recycling of part of the MtM recognised in OCI – would be a “significant departure from general IFRSs regarding the items that result from the forecast transactions”. We believe instead that the issue has not been explored sufficiently and that the reasoning behind this decision requires a better explanation.

Moreover, as an alternative, we believe that in some situations hedge accounting should still be achieved (as it was in IAS 39):

Example

An entity has a net position of FC50 consisting of forecast purchases of FC150 in 12 months' time and forecast sales of FC100 in 20 months' time. This could be hedged for 12 months using a forward foreign exchange contract under which the entity receives FC50 and pays CU25 (i.e. a 2:1 forward exchange rate).

Even if the net position consists of transactions that do not impact the profit and loss at the same reporting period, the entity will correctly argue the following:

- risk management is to hedge FC50 purchases out of FC150 in a 12 months period in accordance with ED/2010/13 par. 35 (designation of a component of a nominal amount);
- risk management is to leave at that moment the remaining position unhedged (i.e. remaining FC100 purchases and FC100 sales);

As a conclusion, hedging FC50 purchases should be still possible in that case since this transaction corresponds to the risk management policy that intends to achieve optimal offsetting and minimise ineffectiveness.

We ask then to the IASB to clarify accounting treatment in such a case.

PRESENTATION

Question 12 - Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or

loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

We do agree.

However, we think that management should exercise its judgement in deciding where the most appropriate location of this single line is in the income statement, taking into account the usefulness of the information and the clarity of presentation.

DISCLOSURES

Question 13 (a) - Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

No, we do not agree.

We acknowledge that disclosures play a fundamental role in understanding the risk management policy of an entity. We also support the IASB that intends to require more judgment compared to IAS 39 (paragraph 40-43).

On that perspective, we would like to draw the attention of the IASB on the importance of use of judgment and therefore would like that these points are emphasized:

- leaving the level of detail of the disclosures “up to” the judgment of the entity is crucial since disclosing all existing information directly or indirectly linked to hedge accounting would “drown” the users of financial statements especially in a situation when the entity has many and often complex activities;
- using judgment will also enable the entity to make a trade-off between existing disclosures already foreseen in its reference document (that includes consolidated financial statements but also – due to regulatory reasons – disclosures on risk management) so that some information do not become redundant because of a rule-based approach on disclosures;
- at last, a judgmental approach will ensure that a trade-off is made for confidentiality purposes.

In addition, we would rather have included the paragraphs concerning disclosures in the application guidance (and not in the standard itself). That would avoid rule-based interpretation of the requirements (these paragraphs being understood as a checklist to be fully filled in by each entity) and would rather enable the entity to prepare relevant information to the users of financial statements.

Moreover, we are concerned about the wording used by the IASB and which reinforces this “checklist” approach, i.e. the wording “shall” is used instead of “may or may not”.

But most notably, we reject the proposals outlined in paragraphs 40(b) and 45-48 of the ED. concerning the amount, timing and uncertainty of future cash flows. As those disclosures should be made ‘for each subsequent period’ and are therefore of a strong

prognostic character, we disagree with the presentation of such extremely sensitive information (e.g. estimates of the amounts of expected hedged items or disclosing hedge ratios), which would give competitors, customers and speculators extensive insights into certain critical estimates.

Question 13 (b) - What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

Please, see our answer to question 14 below.

ACCOUNTING ALTERNATIVES TO HEDGE ACCOUNTING

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?

At the moment, after the discussions maintained so far, it is far from clear to what extent derivative accounting will have to be applied to commodity contracts that used to meet the "own use" exception. It is unclear whether this application of fair value to own use contracts will be mandatory or optional, because it will all depend on whether the application of derivative accounting will be in accordance with the entity's underlying business model and how the contracts are managed. For the time being, we believe that this requisite established by the ED needs further clarification.

We acknowledge that the Board is endeavouring to make provisions which will help eliminate certain accounting mismatches. However, we think that there may be certain situations where treating the own use contract as a derivative may not achieve that aim.

1. Confirmation that accounting treatment should be based on the risk management strategy

We agree with the general principle that accrual or derivative accounting should be applied in accordance with the entity's risk management strategy. However, the solution applied in the context of contracts for non-financial items, where the "own use" exception is to be applied, is still not sufficiently satisfactory.

We believe that the possibility to apply derivative accounting to contracts that used to meet the "own use" exception is an important step forward. Entities dealing with commodities may enter into contracts for physical delivery and account for them as executory contracts. In order to hedge these exposures through derivatives, entities create an accounting mismatch that can be solved by applying hedge accounting as described by the ED.

However, this application of derivative accounting to contracts that could meet the requirements for application of the “own use” exception should be optional. Compulsory application of derivative accounting to “own use” contracts may give rise to accounting mismatches in certain situations, particularly when contracts are linked to assets that are not within the scope of financial instrument accounting and are not accounted for at fair value (e.g. power plant accounted for according to IAS 16), even though they might be managed on the basis of fair value.

Additionally, entities dealing with commodities frequently enter into long term contracts which contain flexibility clauses for their customers; these clauses can be regarded as separate contracts entered into with different management intentions, either “own use” or trading, requiring a separate accounting treatment.

To conclude, we believe that entities should be allowed to apply the “own use” scope exception optionally.

In any case, if the application were mandatory, the requirements for the application of derivative accounting, i.e. that it will be in accordance with the entity’s underlying business model and how the contracts are managed, should be thoroughly clarified.

2. Need of more adequate “unit of account” of a contract

We think that the “unit of account” issue is not adequately solved since it results from the proposal that fair value accounting would apply mandatorily to any own use contracts that are managed based on fair value. This would inevitably result in higher volatility in the financial statements.

As an alternative, we believe that this issue would be more adequately solved if:

- a) derivative accounting would be allowed as an option only ; and
- b) if it can be considered that contracts may be composed of two or more separate contracts for the purpose of IFRS 9 under certain conditions.

We have noted that the IFRIC received in January 2010 a (quite similar) request to add an item to its agenda on providing guidance on whether a contract that can be seen as two separate contracts for the purpose of applying paragraphs 5-7 of IAS 39. At that time, the IFRIC decided not to add this issue to its agenda arguing that the IASB would answer it through its project to replace IAS 39. This request has not been taken into account in the IFRS 9 proposal.

As a consequence, we propose that the following would be added to paragraph 8 of IAS 32 and would replace IFRS 9 proposal:

For the purpose of this Standard, a composed contract to buy or sell a non-financial item can be considered as two (or more) separate contracts under the following conditions:

- a) the contract has two (or more) components that could have been the subject of two (or more) separate contracts, which together would have had exactly the same impact as the composed contract

- b) the cash flows and the risks of the separate components can be clearly identified and measured.

On this question, we refer to the IEAF comment letter for further details, explanations and examples.

ACCOUNTING FOR CREDIT RISK USING CREDIT DERIVATIVES

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?

We consider that if any alternative is adopted for the final standard, the model will be more rules based than principles based.

We do not understand why some components that according to the Board can not be separately identifiable and reliably measurable could have a different accounting treatment that will allow the application of hedge accounting. Indeed, IFRS 9 paragraph 5.7.7(a) requires the credit risk element to be isolated in the case of the fair value option. If that is suitable for that case we think it ought to be sufficiently reliable for hedge accounting too.

Question 15 (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?

Please, see our answer above.

EFFECTIVE DATE AND TRANSITION

Question 16 - Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

We do not agree as we support an effective date of January 1st, 2015 with earlier application permitted for all phases of IFRS 9 because it will take a considerable time period for preparers to accommodate their internal systems and processes to the new accounting provisions.

We support prospective application of the proposed hedge accounting requirements as outlined in paragraph 53 of the ED.

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