

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

### **General comments**

The fundamental objective of the IASB seems to be that hedge accounting should be simplified, made more accessible and easier to qualify for. We support this objective but have some significant comments in the manner in which this is sought to be achieved.

We believe that additional application guidance and examples are needed to ensure consistent application of the proposed standard especially in case of aggregate exposure, accidental offset, rebalancing, and assessment of any ineffectiveness before such rebalancing. The proposed hedge accounting model represents a substantial change from current accounting and further guidance is needed to more fully explain the application of the proposals. The ED only includes a limited number of examples on specific topics and some examples have been posted on the IASB website subsequent to the issuance of the ED. The ED introduces new concepts such as link to risk management, rebalancing, hedge accounting for net positions etc which we believe should be explained further with the help of examples. We believe that preparers, auditors and users of financial statements would benefit from such application guidance.

We have significant concerns with regards to the linkage between risk management strategy and hedge accounting. Some specific concerns are briefly set out below.

1. The level at which risk management objective and strategy should be described is unclear. Currently under IAS 39 the documented risk management strategy is at a very low level, ie, per individual hedge relationship. We believe that if the objective of hedge accounting is to reflect risk management activities, then the level at which risk management is described in the hedge documentation should be consistent with the actual risk management policy. Therefore we expect that this will be high level for many entities. Ideally such policy should also reconcile with the qualitative disclosure requirement of capital risk management under IFRS 7.
2. What constitutes a risk management strategy, and the contents of it are not clear? For example, if the risk management strategy is that the treasurer will take that call on a daily basis, would that meet the requirement of the standard is not clear? To be more precise, ED should identify some basis on who can make such policies and to justify bases for revision of any such policy and only in necessary circumstances.
3. For a relationship to qualify as hedge accounting, one of the requirements is that there is a formal designation and documentation of the hedge relationship and the entity's risk management objective and strategy for undertaking a hedge. Therefore the qualifying criterion for hedge accounting does not require that the risk management objective will be met by the designated hedge relationship, just that the risk management objective is documented.
4. Conversely, where the ED deals with hedge discontinuation, there is a requirement that if the hedge effectiveness objective is not met, consideration must be given as to whether the risk management strategy remains the same. If the risk management strategy has not changed, then rebalancing is required. But ED does not specify with in what time period management

should rebalance such hedge. However, if it has changed, then the hedge relationship must be terminated. This test does maintain a linkage to the risk management strategy, but only if the hedge effectiveness objective is not met.

5. As noted above, the ED requires that hedges that do not meet the effectiveness criteria are terminated if the risk management strategy has changed. What is meant by risk management strategy has changed and at what level such assessment is made is not clear. For example, an entity may have a risk management strategy that 40-50% of its debt should be at fixed rate, with the next 10% having a cap protection. If the risk management strategy changes to requiring all debt to be floating rate, then certainly the existing hedges should be terminated. However, if a decision is made such that 15-20% of the debt is fixed rated and the next 40% to have a cap protection, whether that would constitute a risk management change is not clear.
6. The standard does not prohibit frequent changes in risk management strategy. By changing risk management strategy frequently, it may be possible for entities to move in and out of hedging relationship and manage income statement accordingly.

The proposals within the ED continue to restrict, hedge accounting to risks that could affect profit or loss. For example a common risk management strategy would be for entities to hedge the FX exposure on their strategic foreign currency equity investments designated as at fair value through OCI under IFRS 9. Even if the intent is to hold the equities as a strategic investment, there is no economic reason why it would be inappropriate to hedge the currency risk. The principle that the risks should affect profit or loss has been brought forward from IAS 39, in which all amounts recorded in OCI are eventually recycled to profit or loss. With the move to IFRS 9, in which there is no recycling, we believe that hedge accounting should be permitted for risks which affect profit or loss or OCI.

We also believe that the proposals on macro hedging should have been issued simultaneously along with this ED. Nevertheless, we await those proposals and hope that they would resolve many of the contentious issues faced by banks.

### **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?**

The IASB's proposed model relies heavily on an entity's risk management as a basis for hedge accounting. This is clear from the opening paragraph of the ED which states as follows "The objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss." However the model does not clearly articulate how this is made operational or how risk management strategy is linked to hedge accounting, and therefore the conceptual basis is left one legged.

### **Question 2**

**Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?**

We agree. However, we believe that interest rate collars should qualify as hedge instruments for hedge accounting, even if the purchase and written side of the option were transacted separately, provided the written option is not leveraged or does not on an overall basis expose the entity to a new form of risk rather than serving as a hedge strategy.

### **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 agree with the principle of permitting the designation of an aggregated exposure that is a combination of another exposure and a derivative as a hedged item. However, there is insufficient guidance as to how a combination hedge should be documented, monitored and executed.

We believe that the ED is not clear as to whether derivatives can only be included within a combination as the hedged item unless it had always formed part of any entity's risk management strategy. In some cases the existence of a second derivative might be indicative of a change in risk management strategy which may force any original hedge relationship to terminate. Example in B9(a) of the ED appear to be part of a known rolling risk management strategy. However, if a subsequent decision was made in example B9(a) to start hedging the FX risk, perhaps where volatility from FX rates had significantly increased, could this be designated as a second hedge relationship including the coffee derivatives within the hedged item, or must the first hedge relationship, locking in the USD price of coffee, be terminated due to a change in risk management strategy? In addition, there may be instances where second derivatives should be considered as part of rebalancing rather than including them as part of the hedged item in a second relationship. We recommend that the Board provides further clarification.

It is not clear from the ED whether highly probable forecast derivatives are permitted to be included within a hedged item. Consider an entity that currently has local currency floating rate debt swapped to fixed rate. The swap extends beyond the life of the debt but the entity believes that it is "highly probable" that they will refinance into floating rate debt for at least a period that matches the life of the float/fix swap. As part of the possible refinancing options, the entity decides to issue fixed rate bonds in a foreign currency and immediately swap this to local currency floating (in effect creating synthetic local currency floating debt). Assume that this possibility is included in the hedge documentation. It is not clear from the ED whether the future floating cash flows in the derivative would qualify as a "highly probable forecast transaction" and therefore hedge accounting is permitted for the existing swap and therefore there is no immediate recycling out of OCI if the refinancing occurs. Therefore, we believe it should be possible to combine the anticipated foreign currency debt and the anticipated FX derivative to form a highly probable local currency debt, to be hedged for interest rate risk between now and the

time of the issuance. Accordingly, we recommend that the Board confirms that a forecast derivative is an eligible hedged item.

#### **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 welcome the change introduced by the ED, to permit a broader range of risk components which are eligible for hedge accounting. We believe the change will be helpful, especially for entities in the non-financial services sectors.

However, it is not clear whether a negative margin that occurs on a recurring or systematic basis could be a problem. For example, depending upon the demand and supply conditions, the price of a commodity might be lower than the benchmark even though the commodity was originally priced by adding some profit margin to the benchmark. Negative crack spreads are not uncommon for crude oil and jet fuel due to imbalance of supply and demand. Given that crude oil is physically a component of jet fuel we would imagine that there would be no difficulty in designating crude oil as a component, on the basis that a negative spread would be a short term aberration. In some cases, the component price may exceed the whole price at a subsequent date even though it was not originally expected to exceed the whole. It would be very helpful if the Board could clarify the point that “component” does not have to be defined solely in terms of spot price observations when it is clear that physically, an ingredient, appropriately sized, is a component of an entire finished good.

#### **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 options fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?**

We support the board’s decision.

#### **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 agree that there should be no bright lines and that qualitative effectiveness testing will be permitted. However, we have concerns with the requirements of the standard indicating that a hedge

relationship must produce an unbiased result and rebalancing is required in order to minimize ineffectiveness. Some specific concerns are briefly set out in our response to Question 7 below.

### **Question 7**

**a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why? b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?**

We believe that word ‘unbiased’ should be properly explained. For example, in India, oil prices are regulated and hence are substantially different from global prices. If a consumer of oil in India tries to hedge the risk of oil price with an oil future, it would throw up biased results. Even a deliberate attempt to over or under hedge would constitute a bias. Moreover we feel that though the standard may explain what the meaning of ‘unbiased’ is, it is best left to local regulators and standard-setters to explain the term more in the context of their own environment.

The use of the words ‘unbiased’ in the objective of hedge effectiveness assessment would seem to indicate that all bias should be eliminated both at inception and on subsequent designations. One interpretation is that for subsequent assessments, the existence of bias would always indicate a need to rebalance in order to eliminate it. Without the ability to apply judgment as to the level of ongoing bias that is acceptable, the ED would be more restrictive with a higher operational burden on account of frequent rebalancing than currently required by IAS39. We do not believe that this is the intention of the Board. We note that the US GAAP proposal does not focus on the requirement that a hedge design eliminate all bias; implicit is the acceptability of bias in the design as long as the hedge remains reasonably effective and hedge ineffectiveness resulting from the bias, as well as other imperfections, is appropriately recorded in the financial statements.

We believe that this point will also be critical in convergence discussions. Our preference would be that rebalancing is permitted (rather than mandatory) so that entities have the ability to apply judgment, in line with normal risk management approach.

The guidance in the ED on rebalancing is almost exclusively where a change in volume of the existing hedged item or hedging derivative is required. We believe there will be other situations where rebalancing may be appropriate or desirable. For example, consider the following situations:

- Change in expected timing of hedged item: If a 6 month derivative was used to hedge an expected 6 month cash flow, but the timing of the hedged cash flow changed such that it was expected to occur at 9 months, ineffectiveness would occur. From a risk management perspective a FX swap may be transacted

to convert the existing 6 month FX forward into a 9 month delivery, improving the effectiveness of the hedge relationship. We believe that layering on the FX swap should be permitted as part of rebalancing.

It is not clear from the ED whether such changes to hedge relationships are part of rebalancing, or whether rebalancing is purely a change in volume and the above scenarios would be treated as a change in risk management strategy.

#### **Question 8**

**a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why? b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?**

We support the board's decision on these matters.

#### **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?**

We do not agree with the ED's proposal 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, as the primary financial statements may look cluttered, depending on the number of hedge relationships entered into by an entity. Further, the resulting assets and liabilities would not meet the definitions of such items in the framework. Also, para 26(b) of the ED states that the separate line item shall be presented next to the line item that includes the asset or the liability. Applying this requirement, it is likely that there will be hedge adjustments that are negative figures on the assets/liabilities sides of the balance sheet and this might seem counter-intuitive.

Overall we recommend aggregated disclosures with detail break-up provided in the notes to the financial statements.

#### **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 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 (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 support the board's decision to deal with the issue of profit and loss volatility due to the time value component of options and we generally agree with the proposals set out in the ED.

#### **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?**

Whilst we generally agree with the criteria proposed for groups of items as a hedged item, it is unclear from the ED whether the proposals are applicable for just closed portfolios or whether the proposals are also applicable for open portfolio cash flow hedges.

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

We agree with the proposals.

#### **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?**

In addition to the requirements in IFRS 7, paragraph 40 of the ED requires disclosures of further information. Whilst we agree in principle, with the disclosure proposed in the ED, we are concerned that the information required to be disclosed is extensive. Efforts should be made to reduce the volume of disclosures.

#### **Question 14**

**Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?**

We agree with the proposals.

#### **Question 15**

**a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not? b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?**

We are aware that many banks and financial institutions have long wanted to achieve hedge accounting for credit risk using credit derivatives. We acknowledge that the topic is complex and that it is only reasonable to expect that a solution, if any, will be arrived at after detailed analysis and lengthy deliberations. We therefore urge the Board to reconsider the issue, perhaps as part of the portfolio hedging project.

#### **Question 16**

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

We agree with the proposal that the standard should be applied prospectively.

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