

**International Accounting Standards Board**

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Transmitted by email to: [commentletters@iasb.org](mailto:commentletters@iasb.org)

Paris, 9 March 2011

**BPCE's response to the Exposure Draft "hedge accounting"**

Dear Sir David,

BPCE welcomes the IASB invitation for comments on the Exposure Draft "Hedge accounting". Groupe BPCE is the second largest banking group in France in terms of retail banking.

BPCE supports the aim of the review of the current hedge accounting principles which is to reflect the entity's risk management activities. However, at this point, BPCE does not have all the elements to fully validate the IASB proposal.

We welcome the proposals to remove a number of important restrictions to hedge accounting that exist in IAS 39. More precisely, we agree with the following proposals :

- Hedge effectiveness: we agree with the removal of the quantitative 80-125% hedge effectiveness threshold, the introduction of a principle-based qualifying criterion and a qualitative or quantitative assessment depending on the complexity of the hedge relationship. Moreover, we agree with the removal of the retrospective hedge effectiveness test.
- Hedged items: we agree with the amendment made on eligible hedged items in order to better reflect risk management activities (aligning eligible portions of non financial items with those of financial items, extending the use of layer, allowing designation of a hedging relationship on a net basis,...).
- The treatment of time value of option as a cost of hedge, avoiding undue volatility in profit or loss.

Nevertheless, the exposure draft still contains a number of restrictions which makes that the risk management approach will not be reflected in the financial reporting or makes the application of hedge accounting still complex.

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**BPCE**

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Therefore, we are concerned by the following proposals :

- The prohibition of designating risk components when these components exceed the total cash flows of the hedged items (i.e. the sub-libor issue).
- The restrictions on instruments with prepayment options that could preclude financial institutions from designating hedged items if an entity uses the layer approach.
- The prohibitions / difficulties to qualify as hedged items risk components of financial instruments such as non contractual inflation or credit risk is contradictory with the principles proposed for non financial items.
- The prohibition of designating as hedged item instruments that will not impact P&L such as equity instrument designated at fair value through OCI (with no recycling) which is not consistent with sound risk management practice consisting in hedging an economic exposure (such as the foreign exchange risk of equities). Moreover, this prohibition is directly linked to an inappropriate treatment under the phase I of IFRS 9 which should be amended.

Furthermore, some proposals seem complex and could raise operational difficulties, notably:

- The detailed treatment and application guidance regarding the time value of options could be simplified
- The distinction between rebalancing and discontinuation is not clearly defined and the follow up of several mandatory rebalancing might be burdensome
- We do not see any added value in the proposed accounting mechanism for fair value hedge based on a two-step approach (OCI and transfer in P&L).

If you wish to discuss our comments further, you may contact Nicolas Patrigot (+ 33 1 58 40 75 93).

Yours sincerely,



**Eric Filliat**  
**BPCE**

## Appendix I

### Detailed comments

#### OBJETIVE 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?**

We agree with the objective to reflect in the financial statements the effect of transactions entered into for risk management purposes.

The current IAS 39 hedge accounting rules do not always allow economic offset of significant hedging activities to be reflected in the financial statements for both financial and non-financial institutions entities. This may create confusion and misunderstanding for users of financial statements.

Therefore, we hope that the proposed objective of aligning hedge accounting with risk management activities will avoid most of the drawbacks of IAS 39. Moreover, we consider that a principle-based approach is better than a rule-based approach.

However, we disagree with the restriction consisting in authorising hedge accounting only for underlying exposure that could affect profit or loss. The ED precludes from designating equity measured at fair value through OCI as hedged item because gain or losses are not recyclable through P&L under IFRS 9. Entities may soundly mitigate this volatility in OCI by contracting hedging instruments.

If IFRS 9 phase I was to be maintained, it would be necessary to allow hedge accounting for a hedged item that impact only OCI, by recognising symmetrically in OCI the effective part of the hedging instrument.

BPCE regrets that, despite IASB's objective to reflect risk management activities in an entity's financial reporting, the restrictions added (for example designating core deposits as hedged items, CDS as hedging instruments, sub-libor as hedged risk,...) make it impossible to translate all these strategies into hedge relationships.

#### 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?**

By principle, we agree that hedging instruments should not be limited to derivatives instruments since entities are also using cash-instruments as hedging instruments for risk management purposes.

## 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?**

Hedge accounting principles which are focused on risk management activities of the entities should recognise the fact that synthetic exposures comprising derivatives are eligible hedged items. Therefore we welcome the proposal. It will align hedge accounting requirements with the way entities are managing in practice their risk exposure during the life of the hedged items, such as the cash flow risk arising on debt instruments bearing interest at floating rate either directly or synthetically through the use of a swap transaction.

## 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 agree with the principle proposed by the ED regarding eligible risk components, which addresses homogeneously both financial and non financial items. We also agree that the risk component must be separately identifiable and reliably measurable.

However, we do not see the rationale behind the IASB's decision to prohibit entities from designating as hedged item inflation component of financial instruments or the credit risk of financial instruments (see question 15). These restrictions are unduly adding arbitrary rules (coming from IAS 39), which seems contradictory with the principle-based approach for hedging risk components as proposed by the ED.

Inflation is an input observable in the market and thus reliably measurable. Moreover, the sensitivity of financial instrument to inflation is well identified by market participants. Therefore, we do not see the rationale leading to preclude inflation (not contractually specified) from hedge accounting.

This is why we consider that the credit risk component of a financial instrument should be eligible as hedged item similarly to any other risk component.

BPCE is also concerned by the prohibition of hedging a libor component of sub-libor financial instruments.

We disagree with the IASB decision to maintain the restriction in IAS 39 regarding the designation of risk components when the designated component would exceed the total cash flows of the hedged item, i.e. the sub-libor issue (economically a risk component may be higher than the contractual cash flow of the hedged instrument, for instance for sub-libor instruments).

This prohibition is not consistent with the principle proposed by the ED on the designation of risk component as hedged items. By principle, a bond paying libor plus margin must be eligible for hedge accounting for the portion related only to the libor risk, whatever the sign of the margin is (negative or positive). This is very similar to a hedge of a fixed rate instrument subsequently to its origination (e.g. hedging a 6% rate bond with a 8%-E3M swap), which is currently allowed by IAS 39 (see AG99D) and still allowed by the ED (§B26).

## **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?**
- (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?**

(a) We agree that an entity should be allowed to designate a layer of the nominal amount (or volume) of an item as a hedged item either in a cash flow or fair value hedge relationship. We consider that, by principle, ineffectiveness cannot result from under-hedge (i.e. designating a hedged amount below the risk exposure), when the objective is to purposely under-hedge a risk exposure. Allowing a layer approach is an appropriate way to address such issue.

(b) The prohibition from designating as hedged item a layer component of a contract that includes a prepayment option raises the following concern:

- BPCE considers that, in the case of portfolio hedging, the designated hedged cash-flows should be determined based on economic rather than contractual cash flows, notably for prepayable instruments: the interest rate risk could be isolated from the prepayment risk using expected cash-flows based on the modelling of customers' behaviour. Therefore, the prohibition proposed by the ED should not prevent from developing a specific approach for hedge relationships on a portfolio basis (either closed or open).

## **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 support the removal of the current highly effective quantitative threshold (80-125%) which is arbitrary and leads to excluding effective hedges from hedge accounting.

We prefer a principle-based qualifying criterion and a qualitative or quantitative assessment of the effectiveness depending on the complexity of the hedging relationship as outlined in the ED. We agree with



the removal of the retrospective hedge effectiveness test as it will probably contribute to align hedge accounting with risk management activities.

Nevertheless, in order to better appreciate the criteria of “unbiased result” and “more than accidental offset” and therefore avoid inconsistencies in the hedge accounting practices, it is useful to set-up a guidance regarding those criteria.

## 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?
- (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?

(a) We are concerned that the rebalancing mechanism, as proposed by the ED, is not simple and clear since very lengthy application guidance is required to explain/illustrate it. Additionally, it could raise operational difficulties in the following areas:

- the level at which the risk management objective must be considered is not specified ;
- rebalancing is mandatory and could lead to reviewing and documenting the hedge ratio at each reporting date ;
- several rebalancings could lead to several burdensome effectiveness assessments based on different hedged items characteristics for each rebalanced portion ;
- the distinction between rebalancing and discontinuation is not clearly defined in the ED.

(b) It seems sound to allow an entity to proactively rebalance a hedge relationship if it is expected that this relationship might fail to meet the objective of the hedge effectiveness assessment in the future.

## 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?
- (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?

(a) While we refer to question 7a regarding the lack of clarity about the interactions between rebalancing and discontinuation, we agree that hedge accounting should be discontinued when the hedging relationship ceases to meet the qualifying criteria.

(b) As long as the risk management objective remains the same, it seems logical to forbid any de-designation of a hedging relationship that still meets this objective.

## 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?**
- (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?**

(a) We agree with the Board's final decision not to fully align accounting for fair value hedges with the accounting for cash flow hedges which would have added undue volatility in OCI.

We are not convinced that recognising the fair value gain or loss of both the hedging instrument and the hedged item in OCI with the ineffectiveness transferred from OCI into profit or loss (i.e. a two-step approach) is useful. The reason is that we do not see any added value as this is not a simplification of the accounting principles nor it will increase the usefulness of the information reported. On the contrary, for preparers this two-step approach will create operational complexity as the new accounting treatment should be developed in several IT systems. Moreover, adding three lines in OCI may undermine the clarity and the understandability of the financial statements. This information could be well-suited in the disclosures.

(b) Similarly with the above paragraph, we consider that adding several lines on the face of the statement of financial position in case of multiple hedge relationships may heavily undermine the clarity and the understandability of the financial statements. Therefore, it would in our opinion, be more relevant to present the effect of hedge accounting on hedged items in a single line in the asset-side and/or the liability side of the statement of financial position. The detailed effect of hedge accounting for each component would be best presented in the disclosures.

(c) Consistently with the above paragraphs, we are not in favour of a linked presentation.

## 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?
- (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?

First of all, we believe that the time value of options represents the cost of hedging (which is known at inception) and should not create undue volatility in P&L, since options, by nature, perfectly offset asymmetrical risk. Therefore, we agree with the accounting for the time value of option for CFH and FVH in OCI. Moreover, we consider that the interest element (forward points) of forward contract (ED §8b) should follow the same treatment since it also represents a cost of hedging.

However, we believe that the requirements set by the ED are adding complexities and could be simplified. For instance, instead of creating a new hedge accounting mechanism specifically for time value of option, this could fit into the current FVH or CFH accounting mechanism.

(a) We agree with recycling the initial time value of options in P&L or as a basis adjustment when the hedged transaction impacts the financial statement, which is consistent with the cost of hedging/insurance premium view.

(b) We agree that time value of options should be deferred and amortised over the hedging relationship in order to properly reflect the cost of hedging.

(c) The new concept of "aligned time value" seems similar to the already known "hypothetical derivative" wording also mentioned in the ED. The meaning of these two concepts should be clarified and the IASB should avoid introducing the same notion behind different words that could create confusion among IFRS users.

Having said that, we understand that this proposed requirement is a way to control the time value that is differed in OCI, this appears to be consistent with the principle of recognising ineffectiveness in P&L, although a less complex method should be explored.



## 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 consider that hedge accounting must be consistent with the risk management policy of an entity. Therefore, we agree that a hedged item could be designated on a gross or net basis, as well as on an individual or portfolio basis, consistently with risk management practices.

We agree with some of the new criteria for the eligibility of groups of items as hedged items, notably requiring managing items on a group basis for risk management purposes. Such criteria underline the link between hedge accounting and risk management.

## 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 agree that the effect of any hedging instrument for a hedge on a net basis of a group of items that affects different line items in the income statement should be presented in a separate line. This would avoid reflecting in each line, on a gross basis, transactions that do not actually exist.

We disagree with IASB's proposal requiring presenting on a separate line the fair value adjustment relating to each individual asset / liability which is part of the portfolio. In particular, it will be difficult to deal with net position with this proposal.

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

We agree with the proposed disclosure requirements that provide improved information about the entity's risk management strategies and the effect of hedge accounting on financial statements.

## 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?**

We wonder about the usefulness of the proposal. For instance, it seems that this alternative could be available only when the net exposure is close to nil, which might be rare in practice.

## 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?**
- (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 welcome that the IASB addresses the issue of hedging the credit risk in its discussions. We regret that the IASB did not handle the hedging of credit risk in the ED whereas this issue significantly impacts financial institutions.

We admit that there is a rationale in the argumentation found in the paragraphs BC221 and BC222 that credit default prices might not be suitable for measuring the credit risk component of a financial instrument. This is true if we are focused on getting the best possible theoretical value of the credit risk.

- But, first of all, such determination is complex if not impossible. In the risk management practice CDSs are used as the best instrument which is available to hedge the credit risk. Such risk management practice is recognised also by IASB in the basis of conclusions.
- Secondly, while we agree that assessing credit risk may be challenging, many entities (mainly banks or insurance companies) are currently managing this risk in practice which is or will become a strategic activity. Moreover, credit derivative is the only and best derivative instrument to economically hedge credit risk, which is commonly used by market participant. If credit derivatives were not an appropriate economical hedging instrument, as the IASB seems to assert, this would raise a huge arbitrage opportunity for market participants. Furthermore, both banks and insurance regulators accept credit derivatives as a hedge of credit risk, under certain conditions. Thus, easing the use of credit derivatives as hedging instruments for hedge accounting would be consistent with the main objective of the ED, i.e. improve the link between accounting and risk management activities.
- Thirdly, asserting that credit risk is not an eligible hedged component (i.e. separately identifiable and reliably measurable) in a hedge relationship does not seem consistent with other IFRS requirements, such as the fair value option for financial liabilities which requires the entity to present the effect of changes in the liability's credit risk in OCI.

Therefore, we believe that, where the hedged item is credit risk, there is not any inherent obstacle to achieving hedge accounting per-se and hedge accounting should be permitted provided that the hedging relationship meets the general requirements for qualification and is consistent with the risk management activities.

We acknowledge that hedge accounting of credit risk may be difficult to achieve in practice in some circumstances, but this could be overcome.

In any case, the three alternatives proposed by the Board are not satisfactory since they are based on fair value option which implies to recognise all changes in fair value in profit or loss, including components that may not be hedged by the entity.

## **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 agree with the prospective application proposed by the ED, which is more operational than a full retrospective one.

Moreover, we support the treatment of hedge relationships that qualify both under IAS 39 and under proposed standard as continuing hedging relationships.

However, the proposed date 1 January 2013 is unrealistic considering all major IFRS changes which entities face currently and in the years to come.

We are of the view that key standards impacting upon financial services activities should have a single adoption date, in order to maintain comparability. This is why we consider that all phases of IFRS 9 should be mandatory applicable at a single effective date with no earlier application.