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Selected Issues about Hedge Accounting (File Reference No. 2011-175)

Dear Ms. Cospers,

We appreciate the opportunity to comment on the Financial Accounting Standards Board's (FASB) Discussion Paper, "Selected Issues about Hedge Accounting (Including IASB Exposure Draft, *Hedge Accounting*)."

We support the efforts of the FASB and the International Accounting Standards Board (IASB, collectively the Boards) to improve their hedge accounting models. The complexity of the current requirements under both US GAAP and IFRS has been criticized as a weakness in financial reporting, and we support the Boards' efforts to reduce that complexity by moving toward more principles-based standards.

Given the ongoing globalization of capital markets, there is a strong need for high-quality, internationally-comparable financial information that is useful for decision-making. As we have stated before, we believe the best way to achieve this objective is to ultimately move to a single set of high-quality global financial reporting standards. Until this can be achieved, however, the continued convergence of standards is critical.

We urge both Boards to jointly deliberate the feedback received from each of the three public releases in the past year that could potentially affect hedge accounting.¹ The fundamental objective of both Boards seems to be the same, and there appears to be sufficient similarity between the principles proposed by the two Boards such that we believe there is room for convergence on the issues being debated. Ultimately, we believe a higher quality, more converged standard will result from joint deliberation of these issues. Further, we believe this approach could best facilitate an eventual move toward a single set of high-quality standards.

On balance, we support the overall direction of the IASB's proposal to align hedge accounting with an entity's risk management activities. Further, we have long believed that the arguments to permit hedging of components of non-financial risk are compelling and comparable to the arguments used to permit the hedging of components of financial risk.

¹ That is, the FASB's 2010 Proposed Accounting Standards Update, "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities" (the Proposed ASU), the IASB's 2011 Exposure Draft, *Hedge Accounting* (the IASB Exposure Draft), and the FASB's 2011 Discussion Paper, "Selected Issues about Hedge Accounting" (the Discussion Paper).

Accordingly, we welcome the IASB's proposals to permit the hedging of risk components for non-financial items. Further, we support the direction of the IASB's proposals to permit qualitative effectiveness testing and the rebalancing of hedge relationships. Having said that, as described in our comment letter to the IASB, we believe there are significant application issues that should be addressed in order for the IASB Exposure Draft to be operational.

Appendix 1 to this letter provides our detailed responses to the *Questions for Respondents* included in the Discussion Paper. Additionally, for reference purposes, Appendix 2 to this letter includes a copy of our comment letter on the IASB Exposure Draft (dated 9 March 2011), which details our views on a number of application issues with their proposal.

* * * * *

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

A handwritten signature in black ink that reads 'Ernst & Young LLP' in a cursive, script font.

Responses to the Questions for Respondents included in the FASB Discussion Paper

Risk Management

Question 1: When an entity uses financial instruments to manage risk exposures in economic hedges but those instruments are not designated in hedging relationships for accounting purposes, do you believe that the proposed guidance would provide useful information about all of the effects of an entity's risk management objectives?

We believe the disclosure requirements in a converged standard should provide useful information about the use of derivatives, regardless of whether hedge accounting is elected by the reporting entity. The economic impact of a derivative on an entity is unaffected by whether the entity utilizes hedge accounting. As a result, we do not support the "application of hedge accounting" as the scoping threshold for derivative disclosures.

Further, we believe risk management disclosure requirements in audited footnotes should be limited to "risks managed with derivatives." We appreciate that a broader disclosure of overall risk management practices (beyond the use of derivatives) may be of value to investors, but believe such disclosures should be provided outside of the audited financial statements. If a converged standard permits hedge accounting for components of non-financial risk (e.g., the crude component of forecasted jet fuel purchases), we appreciate that disclosure regarding unhedged risk components may be necessary. We would support such disclosures as long as they are limited to "the unhedged risk components in an existing hedge."

Finally, we have communicated specific concerns regarding the IASB's proposed disclosure provisions primary related to (a) disclosure of forecasted information and (b) better articulation of an entity's risk management objective and its hedge strategy. For further information, please see the detailed response to Question 13 provided in our comment letter to the IASB, which is included as Appendix 2.

Question 2: Do you believe that the proposed guidance and illustrative examples included in the IASB's Exposure Draft are sufficient to understand what is meant by risk management, how to apply that notion to determine accounting at a transaction level, and how to determine the appropriate level of documentation required? Why or why not?

We are concerned that, as currently drafted, the IASB Exposure Draft is not sufficient to understand what is meant by "risk management," how to apply that notion to the transaction level and how to determine the appropriate level of documentation required. Accordingly, in our comment letter to the IASB, we recommended proposed wording that would better articulate the link between risk management, hedge accounting and effectiveness testing. Our recommended wording incorporates the concept of "reasonably effective" from the FASB's Proposed ASU. For further information, please see the detailed response to Question 1 provided in our comment letter to the IASB, which is included as Appendix 2.

Question 3: Do you foresee an entity changing how it determines, documents, and oversees its risk management objectives as a result of this proposed guidance? If yes, what changes do you foresee? Do you foresee any significant difficulties that an entity would likely encounter in establishing the controls related to complying with the proposed guidance?

In principle, we agree with the IASB's proposal to better align hedge accounting with an entity's risk management strategy. However, we believe the current verbiage in the IASB proposal could create operational and auditability issues arising with respect to how "risk management objectives" are defined.

Because the IASB model offers new opportunities for effective hedges to be designed, such as hedges of components of non-financial items, companies reporting under IFRS that may have shied away from utilizing derivatives in the past may be more inclined to use them in risk management strategies. But aside from companies choosing to take advantage of new opportunities to execute hedges that would newly qualify for hedge accounting, we do not believe that the proposal would cause fundamental changes to how an entity determines, documents, and oversees its risk management objectives. Rather, accounting should follow and reflect, rather than lead, a risk management strategy that is separately and independently developed.

We believe that a converged standard could remedy these concerns by articulating a principle that links risk management, hedge accounting and effectiveness testing in a way that would be less subject to varied interpretations. To this end, we proposed alternative wording in the detailed response to Question 1 provided in our comment letter to the IASB, which is included as Appendix 2. Among other recommendations, we believe a designated hedge accounting relationship should be designated so as to most faithfully represent the risk management strategy.

Question 4: Do you foresee any significant auditing issues arising from the proposed articulation of risk management and its link to hedge accounting? For example, is the information required to be disclosed regarding an entity's risk management strategies measurable and objective? Could the inclusion of an entity's risk management objectives create an expectation gap that the auditor is implicitly opining on the adequacy of an entity's risk management objectives?

Questions 2 and 3 primarily relay our views on concerns relating to the linking of an entity's risk management activities and hedge accounting, our belief that there does not need to be a direct relationship between the two and our suggestions as to how the Boards may alleviate such concerns. We also believe our suggestion would help to address the auditability concern expressed in this question, because it would include a principle that the objective of hedge effectiveness assessments is to ensure that the hedge relationship is expected to be reasonably effective in offsetting the entity's exposure to the designated risk over the hedged term.

As to the question of whether disclosed risk management strategy information is measurable and objective, we have communicated specific concerns to the IASB regarding (a) the disclosure of forecast cash flows and (b) needed clarity regarding the level of granularity at which the disclosures are expected to be made. For further information, please see the detailed response to Question 13 provided in our comment letter to the IASB, which is included as Appendix 2.

Finally, as to whether the inclusion of an entity's risk management objectives could create an expectation gap, we believe constituents will be ill-served if any standard perpetuates the growing myth that auditors opine on the adequacy of an entity's risk management objectives. We believe that hedge accounting should be consistent with, and reflective of, a risk management strategy. Auditor effort, however, must be limited toward auditing the qualification for hedge accounting and the bookkeeping of hedge ineffectiveness thereafter, as opposed to whether or not the hedge was or was not an "advisable" exercise in the first place. We encourage the Board to participate in an open dialogue with the Public Company Accounting Standards Board and other appropriate regulators, to help minimize this expectation gap.

Hedging Instruments

Question 5: Should cash instruments be eligible to be designated as hedging instruments? Why or why not? If yes, is there sufficient rigor to prevent an entity from circumventing the classification and measurement guidance in other relevant accounting guidance (for example, IFRS 9, *Financial Instruments*, and IAS 21, *The Effects of Changes in Foreign Exchange Rates*)? Are there any operational concerns about designating cash instruments (such as items within a portfolio of receivables) as hedging instruments?

We do not object to the IASB's proposal that non-derivative financial instruments measured at fair value through profit or loss (i.e., "cash instruments") should be permitted as eligible hedging instruments. Having said that, we are not aware of many situations where this change will have a significant impact on current practice in that we are not familiar with US constituents expressing a desire for this ability.

Hedged Items-Overall

Question 6: Do you believe that the proposed guidance is sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item (for example, equity instruments measured at fair value through profit or loss, standalone derivatives, hybrid instruments, and components of instruments measured at fair value through profit or loss that are not permitted to be bifurcated)? If not, what additional guidance should be provided?

We believe that any converged standard needs clearer guidance about overall constraints, or lack thereof, in terms of any newly permissible (to either US GAAP or IFRS) hedged items. We do not desire a repeat of the era of differing interpretations of what constituted eligible hedge accounting relationships such as that experienced in the US in the mid-2000's. That said, we support component hedging in the tradition originally established in IAS 39 (for financial items) and that proposed under the IASB ED (for non-financial items) as long as any Board-intended constraints are unequivocally stated and explained.

Hedged Items-Risk Components

Question 7: Do you believe that the proposed criteria are appropriate when designating a component of an item as a hedged item? If not, what criteria do you suggest? Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met? If not, please describe what additional guidance should be provided.

We have long believed that the arguments to permit hedging of components of non-financial risk are compelling and comparable to the arguments used to permit the hedging of components of financial risk. Thus, we welcome the proposal to permit a broader range of risk components to be eligible for hedge accounting. We believe the change will be helpful, especially for entities in the non-financial services sectors.

The IASB Exposure Draft proposes that risk components should be hedgeable “provided that the risk component is separately identifiable and reliably measurable.”¹ On balance, we support the “separately identifiable” and the “reliably measurable” criteria. We believe the proposed criteria can be reasonably applied in practice, given a relatively minor amount of additional clarification. Specifically, we have communicated to the IASB our concerns and suggested clarifications regarding (a) instances in which the component price could potentially exceed the whole item (aka, the “sub-Libor issue”), (b) what is meant in paragraph B14 by “the context of the particular market structure” and (c) additional guidance regarding non-contractual risk components (which is separately discussed in the Question 8 which follows). For further information, please see the detailed response to Question 4 provided in our comment letter to the IASB, which is included as Appendix 2.

Question 8: Do you believe that “separately identifiable” should be limited to risk components that are contractually specified? Why or why not?

No. We do not believe “separately identifiable” should be limited to contractually specified risks.

We do, however, believe it would be helpful to provide additional guidance on how to determine whether or not non-contractual risk components are eligible for hedge accounting. For example, in demonstrating that a component (by virtue either of manufacture or pricing), is a driver of the price of the whole item, additional guidance could be helpful regarding potential factors to consider. As we suggested in our comment letter to the IASB, these factors could include whether:

- ▶ the component is a physical ingredient of the whole item
- ▶ an indicative price list exists which includes the component price in a formula
- ▶ it is common market practice to include the component in pricing
- ▶ there is statistical evidence indicating consistent price sensitivity to the component
- ▶ the risk component is actively traded and therefore liquid prices are readily available

¹ Paragraph 18a of IASB Exposure Draft, *Hedge Accounting* (December 2010)

As an example illustrating this need, recent disruptions in the crude oil market have illustrated how two widely-accepted and readily-utilized crude benchmarks (West Texas Intermediate, or "WTI," and Brent) may behave differently at certain periods of time. (We understand that this divergent behavior can occur when one crude benchmark is oriented to more regional supply/demand forces while the other is oriented to more global supply/demand forces.) We recognize that crude oil is provided in the IASB Exposure Draft as an example of an appropriate component for jet fuel, though also note that the example does not indicate "what form of crude" is an acceptable component (i.e., WTI, Brent, or the specific crude oil that will go into the refinement process for the fuel purchased). This divergent behavior may prompt certain individuals to ask the question, "Is WTI or Brent crude the 'separately identifiable' component?" In the absence of additional clarification as to what qualifies as "separately identifiable," we believe individuals may reach different answers to that question.

For example, some may believe that neither WTI nor Brent crude is "separately identifiable" in any given gallon of jet fuel. While crude is, in fact, an ingredient in the process to refine jet fuel, there may be uncertainty (and a lack of insight on behalf of hedgers) as to which barrels of crude (WTI, Brent, or other) are physically utilized in refinement process. We don't believe the accounting standard should have to rely on a chemical analysis of the specific type of crude oil actually used in the refining process for a particular gallon of jet fuel purchased and burned.

We do not believe it is advisable for standard setting to allow or disallow which components represent hedgeable benchmarks for non-financial risks in the way Statements 133 and 138 did for interest rate risk. Such a task would be too burdensome and could not possibly contemplate all non-financial risks. Rather, we believe qualitative factors such as those outlined above, coupled where necessary with statistical analyses that demonstrate a price relationship between the component and the whole, should be sufficient. In the case of the example we've provided, we do not believe the temporarily divergent behavior calls into question the ability of an airline to utilize either a WTI or Brent crude oil contract in hedging the "crude component" of jet fuel. Given appropriate disclosure of the hedging strategy, we believe investors understand that the use of crude oil contracts mitigates only a portion of the jet fuel price, but that the company's method of risk management is simply to lock in the WTI or Brent crude component. We do believe crude components are "separately identifiable" and an airline should be permitted to utilize either WTI or Brent crude as the defined hedged risk component, given that (1) crude is a separately identifiable ingredient in the process, (2) the forward crude price is reliably measurable (even more than forward jet fuel prices are) and (3) there is statistical evidence indicating consistent price sensitivity to the either WTI or Brent crude components.

We believe this thought process underpins the IASB's proposal, but believe this is a prime example of why additional clarification is needed regarding when non-contractual risk components are "separately identifiable" and therefore eligible for hedge accounting. Without greater clarification, we are concerned that some may interpret "separately identifiable" as an almost unattainable standard for non-contractually specified components. A workable standard would have to avoid the second guessing risk as to whether one must be certain that there is no basis risk between the "actual component" utilized by the producer, and the "market-available component" which is the form of derivative contract used by the hedger. We believe that a converged standard that utilizes qualitative factors such as the five we listed above to describe a "qualifying component" would be workable.

Hedged Items -Layer Component

Question 10: Do you believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population? (For example, do you believe that the sale of the last 10,000 widgets sold during a specified period could be designated a layer component in a cash flow hedge?) If not, what additional guidance should be provided?

We believe that a hedged item (including when a “layer” is the hedged item) should be able to be identified when it takes place, as opposed to at the end of the period (which would result in a “look back period” being necessary to identify the hedged item). Having said that, we believe the FASB’s example in this question misinterprets the IASB Exposure Draft. We do not believe the IASB’s proposal suggests that the “sale of the last 10,000 widgets sold during a specified period” can be designated as a layer component in a cash flow hedge. We believe this example is correctly excluded from the IASB’s proposal since it is inconsistent with the principles of a “defined, but open population” in paragraph B21.

In our comment letter to the IASB, we suggested that this concept (i.e., that it would be inappropriate to designate a hedged layer that requires a “look back period” for the item to be identified) be made more explicit, given the apparent confusion. For further information, please see the detailed response to Question 5 provided in our comment letter to the IASB, which is included as Appendix 2.

Hedged Items-Aggregated Exposures and Groups of Items

Question 11: Do you foresee any operational concerns applying other guidance in IFRS (for example, guidance on impairment, income recognition, or derecognition) to those aggregated positions being hedged? For example, do you foresee any operational concerns arising when an impairment of individual items within a group being hedged occurs? If yes, what concerns do you foresee and how would you alleviate them?

We agree that a converged standard should clarify this point. The IFRS proposal would not require that every member of a fair value portfolio hedge be homogenous with every other member, unlike US GAAP. While we support the IFRS proposal to permit portfolios of non-homogenous items to be hedged with a derivative that would provide reasonably effective offset to the portfolio taken as a whole, one consequence is that it is more difficult to allocate a carrying value adjustment to an individual item in the portfolio for purposes of a specific analysis of that item, such as an impairment analysis. A clear method of allocation to an individual item is also important to calculating its eventual sale or extinguishment.

A converged standard would need to develop an approach for this, such as requiring that an impairment analysis be separate from hedge accounting and focus on the unadjusted carrying value of the particular item that is a member of the portfolio hedge. In this way, impairment of an individual item could not be influenced, either favorably or unfavorably, by the effect of the hedging instrument.

Question 12: Do you believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about an entity's use of derivatives? Why or why not?

We have no particular objection to the concept of permitting an aggregated exposure to be designated as the "hedged item" when that aggregated exposure is made up of (1) a derivative and (2) another exposure. Currently US GAAP preparers address this challenge by designating two derivatives in combination as a hedge of the remaining exposure.

For example, Entity A (EUR functional currency) may wish to lock in the USD price of its coal purchases for the following year. Entity A's coal purchase for the following year is highly probable and priced in USD. Entity A transacts a coal forward in USD fixing the USD coal price, and designates it as a cash flow hedge of coal price risk. Three months later, Entity A wishes to hedge the FX exposure on the fixed USD coal price using a USD/EUR currency forward. The IASB's proposal would permit Entity A to designate the currency forward as a hedge of the combination of the forecasted purchase of coal in USD and the USD-denominated coal forward. This hedge relationship synthetically achieves a fixed coal price denominated in EUR.

In this example, US GAAP would permit the coal forward and the USD/EUR currency forward to be designated in combination as the hedging instrument that addresses the cash flow risk associated with the probable purchase of coal using EUR. But because the coal forward was entered into first, US GAAP would require the hedger to re-designate the coal forward into a new hedge relationship that includes the new currency forward, and the hedger would have to address the sometimes problematic issue of the now off-market coal forward no longer having a fair value of zero.

Because the IASB's approach to the same scenario would simply designate the currency forward anew without needing to touch the designation of the original coal forward, we view the IASB model as more reflective of the way a risk manager would dynamically address an additional risk it newly desires to hedge. The ability to include an already existing derivative as part of an aggregated hedged item would provide more flexibility in aligning hedging strategies with risk management objectives.

Question 13: Do you believe that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group under the proposed guidance and satisfy the proposed hedge effectiveness criteria? Why or why not?

Yes. We support the IASB's proposal in this regard, as we believe it reflects the real-world economics behind how entities manage risk. Specifically, entities often hedge a net exposure or engage in asset/liability matching programs, wherein the net exposure is hedged. We see no compelling reason that the hedge accounting model can't reasonably accommodate these real-world, economically-valid hedging strategies.

Hedge Effectiveness

Question 14: Do you foresee any significant operational concerns, including auditing issues, in determining how to assess whether a hedge achieves other-than-accidental offset? If yes, what concerns do you foresee and how would you alleviate them?

We generally agree with the hedge effectiveness requirements set forth in the IASB Exposure Draft. In concept, we welcome both the FASB and IASB's separate proposed changes, each of which achieve the following, albeit with different approaches:

- ▶ Permit qualitative assessments of effectiveness
- ▶ Maintain the requirement to record actual ineffectiveness in profit or loss
- ▶ Move away from an arbitrary 80-125% dollar offset bright-line test where small differences in levels of ineffectiveness could result in significantly different accounting results (i.e., the "on-off switch" that may result from the "law of small numbers problem")

The IASB's proposed hedge effectiveness assessment as stated in paragraph 19(c) and B27-B39 of the ED comprises three tests. The hedge relationship must meet all of the following:

- ▶ produce an unbiased result
- ▶ minimize ineffectiveness
- ▶ achieve other than accidental offset

All of these terms are new to IFRS (let alone US GAAP) and we have concerns as to their meaning and interpretation. We communicated these concerns to the IASB in Question 6 of our comment letter to the IASB, which is included as Appendix 2. In that letter, we proposed alternative wording, which we believe will alleviate many concerns. Briefly, we proposed a "reasonably effective" threshold, which includes an expectation that (a) the offset is other than accidental and (b) the changes in the value of the hedging instrument will not systematically exceed or be less than the change in value of the hedged item, within tolerance levels considered acceptable for risk management purposes.

We agree that "achieving other than accidental offset" seems insufficient on its own to serve as a criterion for qualifying for hedge accounting, which is why we believe the term "reasonably effective" as used in the FASB's Proposed ASU, should be part of a converged standard. We believe that "reasonably effective" inherently includes the requirement that the offset be "other than accidental." Further, in practice, we believe that in acting in its own self-interest, management strives to execute the most effective, cost-efficient hedges possible given market constraints (i.e., limitations on the market availability of instruments an entity could use to mitigate its specific risk), so we would rarely expect to find companies seeking hedge accounting when the offset relationship was "accidental."

Question 15: Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to analyze hedge effectiveness (for example, how to measure the change in the value of the hedged item attributable to the related hedged risk for nonfinancial items)? If not, what additional guidance is needed?

Given this question's reference to "analyze hedge effectiveness" (i.e., apparently an "assessment" step) combined with an apparent bookkeeping example (i.e., measuring hedge ineffectiveness), we are unclear what aspect is being addressed, but we presume this question is focused on the mechanics of measuring hedge ineffectiveness since both EDs are trying to make the assessment of hedge effectiveness easier to do.

It was not clear based on the FASB's Proposed ASU whether, in an effort to reduce complexity, the FASB intended to require that all cash flow hedgers utilize the same methodology to measure ineffectiveness, and what that methodology may be. In our response last year, we noted that complexity would be reduced, and compliance with the documentation requirements automatically enhanced, if all entities were required to use the same method for measuring cash flow hedge ineffectiveness. From our experience, the prevailing practice by hedgers is to utilize the "hypothetical derivative method." We would support embracing that objectives-based method as the single method to be utilized by all cash flow hedgers in a converged standard. We support the hypothetical derivative approach because it is logical, consistent with finance theory, sufficiently flexible to accommodate a variety of situations, and widely applied in practice, and would be largely embraced by constituents going forward.

As an important aside, we believe that critical to the success of the hypothetical derivative method is the concept (present in the FASB's Proposed ASU) that the hedger be permitted to envision the counterparty credit risk (and own credit risk) of the hypothetical derivative to be identical to that of the actual derivative.

The reality is that the ability to hedge components of risk will reduce the amount of ineffectiveness recognized in earnings because, in general, component hedges are less ambitious and therefore easier to achieve "perfection" for their more modest objectives. In many cases, we expect that cash flow hedges of risk components will result in no, or little, ineffectiveness as basis differences would be avoidable. Timing and sizing differences however could be just as commonplace as they are today, and will remain sources of hedge ineffectiveness. We do not believe prescriptive rules or detailed examples are necessary, assuming a general model has been provided to follow.

Changes to a Hedging Relationship

Question 16: Do you foresee any significant operational concerns or constraints in determining whether (a) a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship or (b) an entity's risk management objective has changed? If yes, what concerns or constraints do you foresee and how would you alleviate them?

We generally support the IASB's proposal regarding the rebalancing concept. In applying the IASB's Exposure Draft to a number of relatively common hedging scenarios, however, we believe it is sometimes unclear how the model should be applied. The following example highlights a number of the issues we have noted.

Assume that in February 2011 a company enters into a 3-month LIBOR based forward-starting interest rate swap intended to hedge the variability in cash flows related to variable rate debt to be entered into later in the year. If in June 2011 the company decides to enter into variable rate debt indexed to 1-month LIBOR (instead of debt indexed to 3-month LIBOR), the following is unclear based on the text of the IASB Exposure Draft:

1. Whether the decision to enter into 1-month LIBOR based debt (instead of 3-month LIBOR based debt) would be viewed as a new “risk management strategy,” thereby causing the hedge to terminate
2. Whether the decision to enter into 1-month LIBOR based debt merely represents an action requiring “rebalancing” under the proposed model, thereby allowing the hedge to continue
3. Whether the decision to enter into 1-month LIBOR based debt requires no action at all, other than to measure the new hedge ineffectiveness, since the change introduces no new bias in either direction

If the decision to enter into 1-month LIBOR based debt is viewed as an event requiring rebalancing (alternative 2 above), we are unclear as to the effect of a management decision *not* to rebalance. For example, does the use of a 3-month LIBOR based derivative to hedge a 1-month LIBOR based risk violate the premise of an “unbiased” relationship, given that there are no boundaries of reasonableness (e.g., “reasonably effective”) around the “unbiased” concept? Does management’s choice to not rebalance lead to the loss of hedge accounting, again counteracting the model’s prohibition on voluntary dedesignations? Does management need to perform a statistical analysis to prove that the shorter tenor risk (1-month LIBOR) does not systematically exceed or fall short of the longer tenor risk (3-month LIBOR) even though they are based on the same LIBOR interest rate curve (albeit with different reset tenors)?

Further, if management decides to add a basis swap to the relationship (swapping 3-month LIBOR for 1-month LIBOR) in an effort to rebalance the relationship, we believe that the IASB ED intends for the “hypothetically perfect” derivative in this rebalanced relationship going forward to be the combination of the 3-month LIBOR based swap entered into in February 2011 (which no longer has a fair value of zero) and an at-market basis swap entered into in June 2011 at a fair value of zero. If we are correct in our definition of the new hypothetical derivative combination, then we believe the concept of “rebalancing” could be one of the most significant benefits to all constituents—both preparers and users—in that it would not require a fresh start to the hedge relationship.

Not requiring a fresh start is not just about avoiding new hedge designation paperwork. Not requiring a fresh start means that the hedger is not “penalized” in terms of calculating hedge ineffectiveness for repurposing an already existing derivative that no longer has a fair value of zero. Not requiring a fresh start also means that users would no longer be confused by trying to understand what the recorded hedge ineffectiveness from repurposing an existing derivative in a new hedge relationship in today’s model is intended to represent.

A converged standard would need to be explicitly clear as to what the hypothetically perfect derivative(s) is/are considered to be post rebalancing. We suggest that the model we describe above (original derivative no longer with a fair value of zero plus new derivative used to rebalance the hedge) is the appropriate new hypothetical derivative.

As drafted, it is unclear how the IASB ED distinguishes a “change in risk management strategy” from a “rebalancing.” In addition, we are not clear as to whether management has discretion in this decision, thereby counteracting the model’s prohibition on voluntary dedesignations. Given the number of potential ways in which the model can be read to apply to such a scenario, we believe further clarification of the approach is necessary to ensure consistent application and reduce the risk of future practice issues.

For these reasons, we have communicated specific concerns regarding the IASB’s articulation of the rebalancing and discontinuance concepts. Specifically, we have proposed different wording to indicate (a) when an entity is required to rebalance an accounting hedge relationship and (b) when an accounting hedge relationship is discontinued. For further information, please see the detailed response to Questions 7 & 8 provided in our comment letter to the IASB, which is included as Appendix 2.

Question 17: Do you foresee any significant operational concerns or constraints relating to the potential need to rebalance the hedging relationship to continue to qualify for hedge accounting? If yes, what concerns or constraints do you foresee and how would you alleviate them?

As noted in our response to Question 16, we believe additional clarification is needed surrounding when entities are required to rebalance the accounting hedge relationship and whether there are any constraints regarding a voluntary rebalancing. As described above, we have proposed different wording to the IASB in an effort to alleviate these concerns.

We have concerns with the wording in the IASB Exposure Draft indicating that a hedge relationship must produce an “unbiased” result and that rebalancing of the hedge relationship is *required* in order to minimize ineffectiveness. Our main concerns are that the wording implies an unnecessary degree of precision, such that rebalancing will be required even for very small changes in hedge effectiveness. Furthermore, the IASB Exposure Draft implies that, since rebalancing is *required* as part of hedge effectiveness testing, an entity may fail to qualify for hedge accounting prospectively if it does not rebalance the hedge relationship, even for small amounts of “bias.”

Said differently, we believe some could interpret the “failure of an entity to rebalance when rebalancing was needed” as resulting in a relationship that no longer meets one of the qualification criterion for hedge accounting (i.e., unbiased). In this way, the IASB Exposure Draft could be interpreted to provide an avenue for an entity to effectively “voluntarily dedesignate” while, in concept, the proposal aims to end that practice.

To mitigate these concerns, we strongly encouraged the IASB to consider the FASB’s proposal that the hedge relationship must be “reasonably effective.” Accordingly, in our comment letter to the IASB, we suggested alternative wording to strengthen the link between effectiveness testing and the qualifying criteria for hedge accounting (including risk management). In our proposed wording, we emphasize

that a tolerance level will need to be applied and that minor sources of ineffectiveness (including those not relevant for the risk management strategy) may be ignored for the purposes of hedge effectiveness testing. In such circumstances, we believe rebalancing should be voluntary.

Accounting for the Time Value of Options

Question 18: Do you believe that capitalizing the time value of an option as a basis adjustment of nonfinancial items (in other words, marking the asset or liability away from market) will improve the information that is provided in an entity's statement of financial position? Why or why not?

On balance, we support the IASB's proposals in this regard, though we have communicated several observations to the IASB related to accounting for the time value of options. For further information, please see the detailed response to Question 10 provided in our comment letter to the IASB, which is included as Appendix 2.

In general, we like the concept of reclassifying a "frozen" OCI balance from a terminated cash flow hedge to the basis of the nonfinancial item to which the former hedge related. Maintaining an OCI balance for what may be many years after the original hedge is long forgotten raises the possibility of inadvertent error, "orphaned" OCI balances and other complexities.

In fact, this concept has precedent in US GAAP. For example, a fair value hedge of a firm commitment to purchase inventory causes a "change in fair value of firm commitment" debit or credit balance to appear on the balance sheet. When the fair value hedge terminates and the derivative is converted to cash, the "change in fair value of firm commitment" debit or credit balance is "closed" into the basis of the newly purchased inventory.

Hedge Accounting and Presentation

Question 19: Do you believe that the proposed presentation of the gains and losses in other comprehensive income will provide users of financial statements with more useful information? Why or why not?

and

Question 20: Do you believe that the proposed presentation of a separate line item in the statement of financial position would increase the transparency and the usefulness of the information about an entity's hedging activities? Why or why not?

We do not agree with the IASB's proposed presentation model for fair value hedges, including the presentation of gains and losses in other comprehensive income. Similarly, we do not agree with the proposal that the gain or loss on the hedged item in a fair value hedge (attributable to the hedged risk) should be presented as a separate line item in the statement of financial position. For further information on both of these issues, please see the detailed response to Question 9 provided in our comment letter to the IASB, which is included as Appendix 2.

Question 21: Do you believe that there is sufficient guidance to specifically link the hedging adjustments to the hedged assets and liabilities that compose a hedged net position with respect to presenting a separate line item in the statement of financial position?

As noted in our response to Questions 19 and 20 above, we generally do not agree with the IASB's proposed presentation model.

Those views aside, with this question, we believe the FASB is asking whether the IASB's presentation proposal for fair value hedges of groups of items is sufficiently clear. In that regard, we believe the IASB's proposal in paragraph 26b (for presentation of fair value hedges in the basic financial statements) and 38 (for presentation of fair value hedges of groups of items) could be made clearer. We believe the IASB staff's supplemental example² of the fair value hedge presentation mechanics does just that. While we do not support this overall presentation approach as previously noted, should the IASB or FASB decide to utilize this approach in their model(s), we hope the Board(s) will consider embedding the example into the final guidance to ensure that the approach is clear for constituents.

Disclosures

Question 22: Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what issues do you foresee and how would you alleviate them? Do you believe that it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?

See response to Question 4.

Other

Question 23: Do you believe that the changes proposed by the IASB provide a superior starting point for any changes to U.S. GAAP as it relates to derivatives and hedging activities? Why or why not? Should the FASB be making targeted changes to U.S. GAAP or moving toward converging its overall standards on derivatives and hedging activities with the IASB's standards?

Given the ongoing globalization of capital markets, there is a strong need for high-quality, internationally-comparable financial information that is useful for decision-making. As we have stated before, we believe the best way to achieve this objective is to ultimately move to a single set of high-quality global financial reporting standards. Until this can be achieved, however, the continued convergence of standards is critical.

We don't believe the question of "superior starting point" (that is, "this or that") is the appropriate vantage point with which to view the task ahead. Very simply, the fundamental objective of both Boards seems to be the same (i.e., improve the hedge accounting model) and there appears to be sufficient similarity between the principles proposed by the two Boards such that we believe there is room for convergence on the issues being debated. We believe both Boards have proposed

² As found at the following address: http://www.ifrs.org/NR/rdonlyres/622B4E2B-85E8-4F9B-ACC7-E0A5CD93DA6D/0/FVhedgemechanics_example.pdf

approaches that can improve hedge accounting, albeit in different ways. As with all proposals, there are merits, shortcomings, and areas requiring greater clarity and debate. We urge both Boards to *jointly* deliberate the feedback received from *each of the three* public releases in the past year that could potentially affect hedge accounting. Ultimately, we believe a higher quality, more converged standard will result from joint deliberation of these issues. Further, we believe this approach could best facilitate an eventual move towards a single set of high-quality standards.



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9 March 2011

Dear IASB Members

Invitation to comment - Exposure Draft *Hedge Accounting*

The global organisation of Ernst & Young is pleased to respond to the IASB's Exposure Draft (ED) *Hedge Accounting*.

Overall, we fully support the Board's efforts to reduce complexity in accounting for financial instruments and to improve hedge accounting as part of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. We are supportive of the principles-based approach and the overall thrust and direction of the proposals to align hedge accounting with an entity's risk management activities. In particular, we welcome the Board's proposals to permit:

- ▶ risk components of non-financial items to be designated as hedged items;
- ▶ derivatives to be designated as eligible hedged items in combination with other exposures;
- ▶ qualitative effectiveness testing; and
- ▶ the rebalancing of hedge relationships.

We are also pleased that the Board has eliminated the 'bright lines' set out in IAS 39 for hedge effectiveness testing.

Nevertheless, we believe there are significant application issues that must be addressed by the Board in order for the proposals to be operational. Below we discuss the most significant concerns we have with the proposals.

Risk management

The IASB's proposed model relies heavily on an entity's risk management strategy as a basis for hedge accounting, but we have concerns as to how this can be made operationally consistent with the constraints placed by the ED on hedge accounting. We believe that the Board should articulate better the link between risk management and hedge accounting, and how these are allowed to differ, because, in the absence of a well defined conceptual basis, preparers and auditors will struggle to make appropriate and consistent judgements in the application of a principles-based standard.

We set out in Appendix II, for the Board's consideration, suggested wording to articulate better the link between hedge accounting and risk management. We believe that the accounting hedge relationship should be permitted to differ from the approach taken for risk management, to enable the hedge accounting to be a more faithful representation of the risk management strategy. This would apply either because the risk management strategy is specific to a business rather than to the reporting entity as a whole, or because of the restrictions on hedge accounting set out in the ED (see our response to Question 1).

We are also concerned that the concept of 'risk management strategy' as set out in the ED is not clear, in particular as to the scale of its application. As used in the ED, the risk management 'strategy' or 'objective' appears to be intended to operate at a micro level, with a one-to-one relationship between each strategy and each accounting hedge relationship. It may be a challenge to apply the concept to high level strategies such as a requirement for "no more than 50% of an entity's debt to be at fixed rate". The terminology needs to be made clearer and the principles field tested to ensure that they are operational in more complex applications.

The ED proposes to continue to restrict hedge accounting to risks that could affect profit or loss and it is not clear why this requirement has been retained. Under IAS 39 all changes in the fair values or cash flows of recognised financial instruments ultimately affect profit or loss, but under IFRS 9, entities may designate equity investments at fair value through OCI and the amounts recorded in OCI would never be recycled to profit or loss. With the ED's proposed restriction, it would not be possible to hedge the foreign currency risk of such investments and we urge the Board to reconsider why such a restriction is necessary.

Effectiveness testing, rebalancing and discontinuation

We generally agree with the hedge effectiveness requirements set out in the ED. We are also generally supportive of the new principle of rebalancing introduced by the ED so as to avoid the de-designation and re-designation of accounting hedge relationships as a result of changes in the hedged item or the effectiveness of the hedge that occur over the hedged term. However, we have concerns with the wording in the ED which seems to indicate that a hedge relationship must always produce an 'unbiased' result and that rebalancing of the hedge relationship is *required* in order to minimise ineffectiveness. Our main concerns are that the wording implies an unnecessary degree of precision, such that rebalancing will be required even for very small changes in hedge effectiveness. Furthermore, the ED's wording implies that, since rebalancing is *required* as part of hedge effectiveness testing, an entity may fail to qualify for hedge accounting prospectively if it does not rebalance the hedge relationship, even for small amounts of 'bias'. These concerns are elaborated in our responses to Questions 6 and 7.

In order to mitigate these concerns, we strongly encourage the Board to re-write these sections and to consider the US FASB's proposal that the hedge relationship must be "reasonably effective". Accordingly, we set out in Appendix II, our suggested wording to strengthen the link between effectiveness testing and the qualifying criteria for hedge accounting (including risk management). In our proposed wording, we emphasise that a

tolerance level will need to be applied and that minor sources of ineffectiveness (including those not relevant for the risk management strategy) may be ignored for the purposes of hedge effectiveness testing. If our proposal to apply a more judgemental approach to effectiveness testing were to be adopted, we agree that rebalancing should be required (rather than permitted) whenever the accounting hedge relationship is no longer expected to be reasonably effective.

Similarly, since we believe our proposed wording enhances the link between risk management and hedge accounting (and deals with differences that may arise between the two), we would support the requirement to terminate a hedge relationship (or a portion thereof) if the entity's risk management strategy has changed such that it is no longer compatible with the hedge accounting relationship.

However, we do not agree with the ED's proposal to preclude voluntary discontinuation of a hedge relationship if the risk management objective continues to be met. We believe this is inconsistent with the fact that hedge accounting is, in the first place, voluntary. The prohibition seems to be one of form rather than substance because an entity could discontinue a hedge relationship at any time, for instance, by closing out the derivative and transacting a new one or by changing its risk management strategy prospectively. In addition, there are situations where a voluntary de-designation may be desirable, as we explain in our response to Question 8, in order to align the accounting hedge relationship more closely with the risk management strategy. We therefore recommend that voluntary discontinuation be permitted and the related disclosures be enhanced.

Fair value hedge mechanics

We do not agree with the proposals to change the fair value hedge mechanics. They would be unnecessarily complex to operate, would clutter the primary financial statements and result in the separate recognition of assets and liabilities that would not comply with the *Framework*. We agree that there is value in the information that would be provided, but that it would be better presented in a separate note to the financial statements. Our detailed response is set out under Question 9.

Groups of net positions, macro hedging

We generally agree with the criteria proposed for groups of items as a hedged item. However, we believe these provisions may have a relatively restricted application, as elaborated in our response to Questions 11 and 12. We also believe many of the important issues relating to hedges of groups of items still need to be addressed in the macro hedging project. The macro hedging project is very important, particularly for banks and financial institutions. The key issues we would like the Board to consider in this project include:

- (i) the designation of the bottom layer in a portfolio of prepayable debt instruments
- (ii) designation of gross positions, even though risk management is performed on a net fair value basis
- (iii) the eligibility of demand deposits in a fair value hedge.

It is also possible that some of the concerns relating to the linkage between the risk management strategy and the designated accounting hedge relationships (which we described earlier) may need to be addressed in the macro hedging project if they cannot be solved for the general hedge accounting model.

We also believe the Board should address macro cash flow as well as fair value hedges in its macro hedging project. While the development of the macro fair value hedge model may remove many of the obstacles which have led to the use of the IAS 39 macro cash flow model, it is likely there will remain instances when an entity's risk management activities are best represented by the use of a macro cash flow model.

We appreciate that the Board will consider the feedback received on the general hedge accounting model in deliberating its proposals for the macro hedging model. We are encouraged by the fact that the Board is prepared to modify the general hedge accounting model, as necessary, based on its work on the macro hedging model.

Disclosures

In principle, we agree with the disclosures proposed in the ED. However, we believe the articulation of the linkage between an entity's risk management and hedge accounting strategies has implications for the disclosures that need to be made. We have made suggestions on how to deal with this in our response to question 13.

We also have an important concern that some of the information required to be disclosed concerning an entity's exposures (such as forecast foreign currency denominated purchases or sales) is not appropriate for inclusion in the financial statements. While it is possible for management to attest to, and auditors to opine on, forecast cash flows that are *highly probable*, the total forecast cash flows are too uncertain. Such information is also inconsistent with what is required under other reporting standards and we question whether such information would be useful.

Application guidance

The proposed hedge accounting model represents a substantial change from current accounting and, as we have set out, presents a number of operational issues that need to be addressed. We encourage the Board to continue its outreach process and recommend that amendments to the model are discussed with constituents and subjected to field tests. We also believe that additional guidance and examples are needed to more fully explain the application of the proposals and to ensure they are applied consistently. This includes guidance on, for example, designating derivatives as hedged items in combination with other exposures, identifying non-financial risk components that are not contractually specified,

assessing effectiveness and measuring ineffectiveness after rebalancing. These are described in our responses to Questions 3, 4, 6 and 7.

Consequential amendments to other standards

We are very concerned by the Board's decision not to expose consequential amendments to other IFRSs. We do not believe that appropriate due process can be followed if consequential amendments are not exposed prior to the final standard being issued. As we have mentioned in earlier comment letters, we believe it is essential that the Board includes the full text of all amendments in their exposure drafts, both for this project and other projects. It is not possible to fully evaluate the consequences of the amendments without seeing them in their entirety. In addition, we believe that the Board's failure to expose such consequential amendments increases the likelihood that such amendments will need to be revised in the future as unintended consequences that would likely have been identified during an exposure phase are later identified. We strongly recommend that the proposed drafting is made available for interested parties to review prior to the completion of the Standard.

We strongly agree with allowing (rather than requiring) certain own use commodity contracts to be recorded at fair value through profit and loss, but it is difficult to respond properly until we see the proposed wording.

IFRS-US GAAP convergence

In our comment letter to the FASB in September 2010, we supported the FASB's efforts to simplify hedge accounting mainly by moving from a "highly effective" standard to a "reasonably effective" standard and by permitting qualitative hedge effectiveness assessments. However, we also urged the FASB to follow the outcome of the IASB hedge accounting project and evaluate its preliminary conclusions for possible incorporation into the FASB hedging model.

The fundamental objective of both the IASB and the FASB for this project seems to be the same, that is, hedge accounting should be simplified. There seems to be sufficient similarity between the principles proposed by the two Boards that we believe there is room for convergence on hedge accounting. Throughout our detailed responses in Appendix I, we highlight key aspects of hedge accounting that we would like the two Boards to address together and where we believe that our proposals would make convergence easier. To that end, we are pleased to note that the FASB has issued an invitation to comment on the IASB's hedge accounting ED. We reiterate our belief that a converged standard for financial instruments is necessary in the long run and, therefore, we strongly encourage the Boards to work together expeditiously to achieve a comprehensive and converged solution.



Our responses to the specific questions posed in the ED are set out in Appendix I to this letter. Should you wish to discuss our comments further, please contact Tony Clifford at the above address or on +44 (0)20 7951 2250.

Yours faithfully,

A handwritten signature in cursive script that reads 'Ernst & Young'.

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Appendix I - Responses to the questions in the Exposure Draft *Hedge accounting***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?

We agree with the proposed objective, to reflect in its financial reporting, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks. We believe this is a helpful step forward and facilitates a reduction in complexity by moving towards a less rules-based standard.

The requirement to document an entity's risk management objective and strategy is not completely new since it currently exists in IAS 39 and US GAAP. However, under existing standards there is no explicit requirement for hedge accounting to be *consistent* with actual risk management. Therefore, hedge documentation often includes a generic description of risk management activities that may not be wholly consistent with the *actual* risk management strategy for economic purposes. Given this current practice, we are supportive of the ED's proposals that will require entities to develop hedge documentation that is more specific and consistent with actual risk management activities. We also believe this is an area where the IASB and the FASB could achieve some level of convergence and, therefore, we strongly encourage the two Boards to use similar wording in their respective proposals/standards.

Having said that, we have a number of concerns on how the link between risk management and hedge accounting is articulated, as detailed below.

Risk management activities that differ from the objectives of hedge accounting

We believe there are still a large number of risk management activities where the ED, as worded, would not permit hedge accounting. Consider the following examples where the risk management strategies are different from the entity's objectives for applying hedge accounting:

- ▶ Banks typically pass on the interest rate risk on their banking book to the trading book by using internal derivatives; the internal derivatives then form part of the trading book risk position that is managed within its delegated risk limits. Therefore, it is possible that there will not be an external derivative that matches each internal derivative between the banking book and the trading book. Since the ED precludes the use of internal derivatives as hedging instruments, there will be an inconsistency between the bank's combined risk

management strategy and the permitted hedge accounting¹. The problem arises, in this example, because risk is managed differently for each business and there isn't just one entity-wide risk management strategy. In this situation banks currently will often identify the most suitable external derivatives on its books, even if they are unrelated to the actual risk management strategy, to designate as proxy hedging instruments.

- ▶ An entity may have a risk management strategy to hedge the *future* highly probable foreign currency profits from its overseas subsidiaries. However, this is not an exposure eligible for hedge accounting under existing standards or the new proposals. As a result, the entity may use net investment hedging to achieve hedge accounting instead.

Other examples of where common risk management strategies *may not* be eligible for hedge accounting according to the proposals include:

- ▶ cash flow hedges of net positions where the hedged items impact profit or loss in different reporting periods;
- ▶ fair value hedges of demand deposits and fair value hedges of a 'bottom layer' of assets prepayable at other than fair value, in which the entity includes 'behavioural' considerations in its risk management strategy;
- ▶ designation of net written options as hedging instruments in combination with other instruments, such that the combined hedging instruments are not net written options;
- ▶ use of basis swaps to match floating rate risk between financial assets and liabilities;
- ▶ forecast intra-group foreign currency transactions (such as royalty streams and management charges); and
- ▶ (once IFRS 9 has been introduced), foreign currency hedges of equity investments recorded at fair value through OCI.

Because of the ED's requirement for consistency between an entity's risk management objectives and its hedge accounting, it is not clear whether hedge accounting is precluded in these instances, or whether hedge accounting can be achieved by designating the hedge relationship in a manner that is not fully consistent with the entity's risk management activities.

The anticipated ED on portfolio hedging may provide hedge accounting solutions for some of the above risk management strategies, but not all. Under IAS 39, entities are sometimes able to achieve hedge accounting by designating hedges in such a way as to comply with the standard, even if this differs from what they had intended for risk management purposes. We have already referred to the designation of external derivatives as proxies for internal derivatives and the use of net investment hedging. As another example, banks may enter into derivatives with the intent of managing the interest rate risk on fixed rate pre-payable

¹ IAS39 IGC F1.4 indicates that trading book swaps are acceptable as a proxy for internal banking book swaps, however without this guidance it is not clear that these would be acceptable under the ED.

assets, but may designate them for hedge accounting purposes as cash flow hedges of floating rate liabilities. The intent of the ED does not seem to be to preclude entities from continuing to achieve hedge accounting in these instances, but we are concerned that this practice would not be permitted, given the current wording. In such circumstances, we believe it should be possible for entities to achieve hedge accounting to best represent what the entity was seeking to accomplish through its risk management strategy, provided any departures from the risk management strategy are restricted to those necessary to comply with the qualifying criteria for hedge accounting. For instance, we are not suggesting that internal derivatives should be eligible hedging instruments, just that entities should be able, as now, to designate external derivatives as proxy hedging instruments. In these circumstances, entities should be required to describe the actual risk management strategy, how it differs from the approach used for hedge accounting and why hedge accounting cannot be designated in a similar manner.

We also note that the qualifying criteria set out in the ED (paragraph 19) do not require that the risk management objective will be met by, or be consistent with, the designated hedge relationship, just that the risk management objective is “documented”.

In order to address concerns such as those mentioned above, and to make the ED’s proposals operationally feasible, we believe that the Board should articulate better the link between risk management and hedge accounting, and how entities should address differences that arise. We set out in Appendix II for the Board’s consideration, our proposed wording, which is intended to provide a clearer articulation of how this link should work.

The level at which risk management strategy is described

Once it is clarified that there need not always be a direct relationship between risk management activity and hedge accounting, it would be helpful to clarify the terminology, to make it clearer when the ED is referring to the hedging carried out for risk management activities, and when for accounting purposes. For instance, we recommend that ‘hedge relationship’ in the ED is reworded as ‘accounting hedge relationship’, since that appears to be the sense in which the phrase is used.

The ED makes reference to risk management “activities”, “objectives” and “strategy”. However, these terms are undefined and it is unclear if they are intended to be interchangeable or have different meanings. We urge the Board to clarify the meanings and to use consistent wording unless a different meaning is intended, as we believe this is important in the context of the level at which risk management strategies should be applied for hedge accounting. The word ‘strategy’ would imply a high level management approach, such as “no more than 50% of the entity’s debt should be at a fixed rate”. Yet the application of the terms ‘strategy’ and ‘objective’ in the ED seem to be at a much lower level, so that there is a one-for-one relationship between each strategy and each hedge relationship. This may be valid for relatively simple hedge strategies but not for more complex ones undertaken by sophisticated treasury operations. In addition, it is unclear to us whether a risk management ‘objective’ means the intent behind the ‘strategy’, or a tactic for executing the strategy.

For example, in the financial services sector, risk management is typically considered at the portfolio level, but large items such as the issuance of subordinated debt are usually considered individually. However, even then, the influence of other exposures on the balance sheet may impact the risk management strategy for subordinated debt.

If the objective of hedge accounting is to reflect an entity's risk management activities, then the level at which risk management strategy should be considered (and described in the hedge accounting documentation) should be consistent with the actual risk management approach. We therefore recommend that the Board clarify how the concept of the risk management strategy is intended to be applied, as well as the meaning of the terms 'strategy' and 'objective' in this context. We also recommend that the principles are field tested to ensure that they are operational for both more complex as well as smaller applications.

Note, also, that if an entity's risk management 'strategy' is set at a high level, such as "no more than 50% of the entity's debt should be at a fixed rate", then the hedge activity may involve adjustments as new debt is issued or old debt retired, even though the overall strategy is unchanged. Hence the accounting hedge relationship may need to be adjusted even without a change in the strategy.

The need for hedged risks to impact profit or loss

The ED's proposals continue to restrict hedge accounting to risks that could affect profit or loss. We believe the restriction in IAS 39 was appropriate because all amounts recorded in OCI would eventually be recycled to profit or loss. Under IFRS 9, entities would be able to designate equity investments at fair value through OCI, although amounts recorded in OCI would never be recycled to profit or loss. Therefore, it is not clear why the Board has decided to retain the restriction in the new hedge accounting model. A common risk management strategy would be for entities to hedge the FX exposure on foreign currency equity investments that may be designated as at fair value through OCI. Even if the intent is to hold the equities as strategic investments, there is no economic reason why it would be inappropriate to hedge the currency risk. We believe the IASB should reconsider why it is necessary to prohibit hedge accounting for exposures that affect OCI.

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 agree that non-derivative financial instruments measured at fair value through profit or loss should be permitted as eligible hedging instruments. Having said that, we are not aware of many situations where this change will have a significant impact.

It is not clear why individual written options are excluded from eligible hedging instruments even when combined with other instruments such that the combination is not a net written option. As noted in paragraph 11 of the ED, certain derivative instruments such as collars have the characteristics of a combination of written and purchased options yet they are permitted as hedging instruments as long as the combination is not a net written option. However collars are often transacted as separate caps and floors, one of which will be a written option and we believe hedge accounting should be permitted for such collars. US GAAP has always permitted use of written options in the scenarios described above when the combination of the hedging instruments is not a net written option.

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 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.

As worded, it is possible to read the ED's proposals to permit synthetic accounting, so as to achieve amortised cost accounting for derivatives. We do not believe that this is the intent of the ED, and would recommend that the Board makes this clearer.

We also believe that there is insufficient guidance how a combination hedge should be documented, monitored and executed. The example in B9(a) layers a hedge of foreign currency risk (the "FX hedge") on top of a cash flow hedge of market risk for the coffee purchases (the "market risk hedge"). The example in B9(b) layers a cash flow hedge of 2 year interest rate risk exposure (the "2 year hedge") on top of a fair value hedge of interest and foreign currency risk for the 10 year debt (the "10 year hedge"). Neither paragraph 15 nor B9 explicitly state whether the market risk hedge or 10 year hedge (the "bottom relationships") must first qualify as a valid hedging relationship on their own or whether they should automatically achieve some form of hedge accounting simply because the FX hedge

and the 2 year hedge (the “top relationships”) meet the requirements set out in paragraph 19. We believe that the bottom relationship in a hedge of combined exposures should, or, if the derivative is a forecast transaction (see the discussion below) would, first qualify and be/will be accounted for as a valid hedging relationship, before considering the qualification of, and accounting for, the top relationship. We recommend that the Board makes this clarification.

In addition, it is not clear whether a derivative can be included within a combination as the hedged item if it has not always formed part of an 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. Both examples in B9 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 the overall risk management strategy, even though the market risk hedge (coffee price) has not changed?

Furthermore, there may be instances where second derivatives should be considered as part of a rebalancing rather than including them as the hedging instrument in a second relationship. For example, if an additional FX swap was transacted to match the revised timing of a hedged item in an existing hedge relationship, then we believe that this should be treated as rebalancing. This scenario is considered further in our answer to Question 7. We recommend that the Board provides further clarification.

Whilst we understand how the effectiveness assessment would work for hedges where the hedged item includes a derivative, it is less clear for effectiveness measurement purposes. For hedges of derivatives, we believe additional guidance on effectiveness measurement is required to make the ED’s proposal operational, in particular where the existing derivative is part of a cash flow hedge and the second derivative would be designated within a fair value hedge. This is because fair value changes for the existing derivative are recorded in OCI as part of the cash flow hedge, yet, in a fair value hedge, the fair value adjustment to the hedged item should be recorded in the balance sheet. It would be helpful if the Board can clarify whether it is appropriate to record the changes in the fair value of the combined hedged item in OCI. The issue is explained further in the following example.

An entity with GBP functional currency issues 10 year USD floating rate debt and swaps to GBP fixed for 10 years. At inception it swaps the first 2 years to GBP floating. The risk management strategy is to take advantage of falling rates in the short term but to have certainty of interest costs from year 3 to 8. We believe that the ED permits the swaps to be designated within separate hedge relationships as follows:

	Hedge 1	Hedge 2
Hedged item	10 year floating rate USD debt	2 year fixed rate GBP debt (USD debt plus cross currency swap)
Hedging instrument	10 year cross currency swap, receive USD floating, pay GBP fixed	2 year interest rate swap, receive GBP fixed, pay GBP floating
Hedge type	CF hedge	FV hedge
Accounting for hedged item	Amortised cost plus IAS21 spot translation	ED requires FV movements on hedged items to be posted to BS and OCI, with ineffective portion taken to profit or loss. FV movements for the cross currency swap are already posted to BS and OCI as part of hedge 1, therefore no additional offset is available.
Accounting for hedging instrument	FVTPL with effective portion taken to OCI + recycling of spot FX movements	Effective portion taken to OCI

Ordinarily under the ED, for fair value hedges, the change in fair value of the hedged item and hedging instrument will offset in OCI. However, as the majority of fair value movements of the combined hedged item (driven by the cross currency swap rather than changes in fair value of the debt) are recorded in OCI as part of the existing cash flow hedge, the normal offset we would expect with fair value hedges will not occur. The net effect is that the majority of the gain or loss on the second hedging derivative will be recorded in OCI as if it were a cash flow hedge. It would be helpful if there was guidance which confirms that this is the appropriate treatment. (There may be some small amendment to the hedged debt for fair value movements, but as it is floating rate this would be restricted to the fair value of the most recently fixed floating leg. The amount of ineffectiveness would be measured on the basis of the combined hedge exposure.)

We have an additional point in relation to drafting. It is not clear whether highly probable forecast derivative transactions are permitted to be included within a hedged item, as derivatives are expressly permitted as hedged items in a separate paragraph (15) from that which refers to forecast transactions (12). Consider an entity that believes that it is highly probable that it will issue a fixed rate bond in a foreign currency and that, on the issue of the bond, it will immediately swap it to local currency floating rate (in combination, a synthetic forecast local currency floating rate debt). To lock in its borrowing costs in local currency now, the entity enters into a local currency forward starting pay fixed, receive floating interest rate swap. It is not clear from the ED whether the future cash flows in the forecast cross currency swap would qualify as a "highly probable forecast transaction", and, therefore, whether hedge accounting would be permitted for the swap in combination with the bond. We believe it should be possible to combine the forecast foreign currency debt issue and the forecast cross currency swap to be hedged for interest rate risk. Accordingly, we recommend that the Board confirms that a highly probable forecast derivative transaction is an eligible hedged item in combination with an exposure.

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 welcome the change proposed 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.

Although the examples on the “sub-LIBOR issue” are in relation to financial instruments, we understand that the issue is also relevant for non-financial hedged items. Examples might include:

- ▶ A contract to deliver a commodity to a particular location which is cheaper than the price to deliver to the location referenced in a futures contract.
- ▶ Hedging the commodity price using the benchmark. Depending upon the demand and supply conditions, the price 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 between the prices of crude oil and jet fuel due to imbalance of supply and demand.

Given that crude oil is a physical 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. However, it is not clear whether a negative margin that occurs on a recurring or systematic basis may be a problem. 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 a physical ingredient is a component of an entire finished good. If the Board believes that a component should *never* exceed the whole item, we recommend that additional guidance is included (such as the kind of evidence that is required to prove that the component never exceeds the whole).

The ED requires that the particular market structure needs to be considered in determining whether there is a component eligible for hedge designation, although it is not clear what this means. If the Board’s intent is that the component should either be explicitly reflected in the price of the whole item or implicitly reflected in the pricing *by virtue of market convention* then we recommend that the wording be amended to make this clear.

We also believe that additional guidance would be helpful on how to determine whether or not non-contractual risk components are eligible for hedge accounting. For example, there would be a need to understand the pricing drivers and to be able to demonstrate that a

component, by virtue either of manufacture or pricing, is a driver of the price of the whole item. One or more factors may need to be considered, including whether:

- ▶ the component is a physical ingredient of the whole item;
- ▶ an indicative price list exists which includes component price in a formula;
- ▶ it is common market practice to include the component in pricing;
- ▶ there is statistical evidence indicating consistent price sensitivity to the component;
- ▶ the risk component is actively traded and therefore liquid prices are readily available.

Use of hypothetical derivatives

Paragraph B44 of the ED seems to permit the use of hypothetical derivatives for both hedge effectiveness assessment and measurement, for both fair value hedges and cash flow hedges (under IAS39 these are widely used to calculate effectiveness only for cash flow hedges). However, the ED goes on to say that hypothetical derivatives can only be used where not using them would give the same result.

We had read this to mean that the use of a hypothetical derivative to measure fair value hedges would only be appropriate if the actual hedging derivative was the perfect hedge of fair value, i.e. one whose floating rate were to reset daily. Otherwise, use of a hypothetical derivative for measuring a fair value hedge would result in no ineffectiveness being recorded due to changes in the fair value of the nearest floating leg of the hedging derivative, which typically resets three monthly or six monthly.

However, we also note paragraph B82, which would seem to suggest that it is possible to apply fair value hedging to hedge relationships which “transform the cash flows” from fixed to floating. If the objective was to convert the cash flows to three month floating this would be consistent with the use of a fixed v three month hypothetical derivative for a fair value hedge. But it is not clear how this would meet the definition of a fair value hedge, since it would only partly hedge the change in the exposure to fair value. Also, by analogy, a basis swap, such as one that pays three month vs six month interest, would also be eligible as a fair value or a cash flow hedge, since it would ‘transform’ the cash flows.

Hedges that ‘transform’ cash flows and meet the definition of neither a fair value nor cash flow hedge, would represent a significant change in what is permitted for hedge accounting. If it is the Board’s belief that this can be achieved, perhaps by designating an appropriate component, it would be helpful if this were set out explicitly rather than just implied by these paragraphs.

In addition, if the Board does not believe that a fixed to three month transformation is a valid fair value hedge, then we recommend that paragraph B44 be clarified to say that a hypothetical derivative is not normally relevant for measuring a fair value hedge and paragraph B82 be amended or deleted.

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?

We support the Board's decision to permit designation of layer components as hedged items for both individual items as well as for groups. We believe the ability to hedge a bottom/top layer in a fair value hedge is a sensible approach, and permits better alignment to risk management strategy, as compared to IAS 39 which required a proportional approach.

For the purpose of the general hedge accounting model, we support the Board's decision that a layer component of an instrument 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.

Nevertheless, hedging of portfolios or groups of prepayable instruments is often carried out on a behavioural basis. We are aware that achieving hedge accounting for this activity is a contentious issue in some jurisdictions and we believe this is one of the key hedge accounting issues for financial institutions. This is, in part, because prepayments occur for many reasons which are not linked to interest rate changes (such as when the customer moves house, dies or can afford to reduce its liabilities) and banks typically build these 'behavioural' considerations into their risk management strategies.

Therefore, we tentatively support the preclusion of hedging a layer of a group of prepayable instruments for the general hedge accounting model, as we note that the Board is expected to consider this further, as part of the portfolio hedging deliberations. We strongly encourage the Board to attempt to find a resolution to this issue. In addition, although we expect the macro hedging ED will be applicable for open portfolios, we would hope that the guidance would also be applicable to closed portfolios, to ensure an appropriate solution for portfolios with prepayment risk regardless of whether they are open or closed.

We also note that the FASB's request for comment on the IASB's ED mentions the example of whether "the sale of the last 10,000 widgets sold during a specified period could be designated as a layer component in a cash flow hedge". The bottom layer of a highly probable forecast cash flow is not actually identifiable until the end of the period, because it results in the need to "look back". Therefore, we believe this example is correctly not included in the IASB's ED and it would be useful to make this explicit in order to allay the FASB's concerns.

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 generally agree with the hedge effectiveness requirements set out in the ED. We welcome the proposal to permit qualitative effectiveness assessment, whilst maintaining the requirement to record actual ineffectiveness in profit or loss, and the move away from an arbitrary bright line test where small differences in levels of ineffectiveness could result in significantly different accounting results.

Given that all ineffectiveness must be recognised in profit or loss on a retrospective basis, we support the Board's proposal to require the effectiveness assessment to be performed only on a prospective basis. We are aware that some constituents are concerned that removing a need to carry out a retrospective assessment could mean that high levels of actual ineffectiveness are disregarded in making the prospective assessment. To make it clear that actual ineffectiveness cannot be completely ignored, in our proposed wording in Appendix II, we write that ineffectiveness that arises (from the retrospective measurement of effectiveness) in the reporting period may only be disregarded for the purposes of the prospective effectiveness assessment if the hedging relationship is still expected to be reasonably effective over the hedged term.

We have a number of concerns and points for clarification, as detailed below.

The hedge effectiveness assessment as stated in paragraph 19(c) and B27-B39 of the ED comprises three tests, i.e., the hedge relationship:

1. produces an *unbiased* result;
2. *minimises* ineffectiveness; and
3. achieves other than *accidental offset*

All of the terms highlighted in italics are new to IFRS and we have concerns as to their meaning and interpretation, in the context in which they are used.

First, the words 'unbiased result' is not well understood by global constituents and would be better replaced by its intended meaning i.e., 'an expectation that the changes in the value of the hedging instrument will not systematically exceed or be less than the change in value of the hedged item'. Second, the use of the word unbiased seems to indicate that *all* bias should be eliminated both at inception and on an ongoing basis. Similarly, the need to 'minimise ineffectiveness' seems to indicate an unnecessary degree of precision, such that rebalancing will be required even for very small changes in hedge effectiveness. While the last sentence of paragraph B29 states that an entity need not expect a hedging relationship to be perfectly effective, this is inconsistent with the need to minimise ineffectiveness and doesn't

necessarily permit any tolerance for bias (given that a totally unbiased hedge could still give rise to some ineffectiveness).

In the light of our observations above with respect to 'unbiased result' and 'minimise ineffectiveness', we believe it is not clear whether entities are permitted to apply judgement and possibly, a level of tolerance when performing hedge effectiveness assessment and determining whether or not rebalancing is required. Without the ability to apply judgement as to the level of ongoing bias that is acceptable, we believe the ED (as described) is more restrictive, with a higher operational burden, than currently required by IAS39. We do not believe that this is the intention of the Board, based on the last sentence in paragraph B29. Also, the concept of bias seems to have been used more narrowly in some of the Board's discussions than would be understood by reading the ED (the bias originally seemed to address the limited situation currently covered by AG107A). However, given the repetitive use of the terms biased/unbiased throughout the ED, we strongly recommend that the Board expresses the requirements for hedge effectiveness assessment in simpler words, including acknowledging that a level of tolerance will be permissible when performing the assessment and when it should rebalance the hedging relationship.

All three tests in the IASB's ED appear to have a similar aim to the requirement in the FASB's ED that any designated hedges must result in a 'reasonably effective' offset. We note that the FASB's proposal does not focus on the requirement that a hedge design eliminate all bias; instead, there is an implicit recognition that some bias in the design is acceptable, 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. Therefore, in our view, 'reasonably effective' is a more succinct way of expressing the principle, while also permitting the application of judgement when performing hedge effectiveness testing.

Accordingly, we put forward for the Board's consideration our recommended wording in Appendix II, which we believe will alleviate our concerns expressed above. We strongly believe our proposal combines the concepts introduced by both Boards and we believe there is scope for convergence because the objectives for effectiveness testing set out by the two Boards are sufficiently similar. We strongly encourage both Boards to use consistent terminology.

It should be noted that our proposed description of the term 'reasonably effective' includes an expectation that an economic relationship exists between the hedging instrument and the hedged item, which we believe more clearly expresses the concept of 'other than accidental offset'.

In our proposed wording we have replaced the word 'bias' with the expectation that the changes in the value of the hedging instrument will not systematically exceed or be less than the change in value of the hedged item. We have retained the concept because of its inter-relationship with the rebalancing requirements. However, ideally, rebalancing should be based on whether or not an accounting hedge relationship is expected to be reasonably

effective (rather than rely on multiple requirements), in which case the concept may not be needed. If the Board had intended, in part, to restrict bias in order to carry forward the principle set out in AG107A of IAS 39 (as explained by BC136A) into the Standard (in other words, to prevent deliberate under-hedging so as to reduce recognised ineffectiveness for cash flow hedges), we recommend that the Board makes use of some of the language in those paragraphs, to make this point separately and more clearly.

Effectiveness testing for cash flow hedges

A cash flow hedge is defined in IAS 39 and the ED as 'a hedge of the exposure to variability in cash flows'. It has always been unclear under IAS 39 whether it is a hedge of the variability of cash flows or of the *present value* of the variability of cash flows. The ED does not clarify this issue but is silent on the use of discounting for the effectiveness assessment of cash flow hedges (although it is clear that all ineffectiveness is measured on a discounted basis). While some of the guidance in the ED (eg paragraph B38) reiterates the link to risk management activities, suggesting that the effectiveness assessment should be based on information used for risk management, elsewhere, the ED seems more prescriptive.

For example, throughout the ED there is reference to effectiveness being assessed by comparing the 'change in *fair value* of the hedging instrument with the change in *fair value* or *cash flows* of the hedged item'. In other instances hedge effectiveness is referred to with regard to the change in *fair value or cash flows* of the hedging instrument. As with IAS 39, it is not clear whether references to changes in 'cash flows' should be interpreted to mean offset can be considered with respect to just cash flows in some circumstances, without consideration of their timing. (Some of the IAS 39 Interpretation Guidance implies that this is the case but other parts of the Standard are not consistent²). The ED specifically requires discounting for measuring ineffectiveness but this inconsistent wording on the use of fair values or cash flows is confusing on the possible use of undiscounted cash flows for assessment purposes.

Whilst it is common risk management practice for the timing of hedged and hedging cash flows to coincide, ongoing risk monitoring does not always focus on changes in fair value, in particular for cash flows hedges. For example:

- ▶ Although management will monitor the credit exposure from their derivative counterparties they would not routinely consider changes in fair value of derivatives due to minor changes in credit risk, as part of their assessment of the performance of hedging activities. Only if management no longer expected the derivative counterparty to perform on the derivative would the hedge effectiveness assessment be affected.
- ▶ Existing (or off-market) derivatives with a non-zero fair value may be designated in cash flow hedge relationships, for example an existing interest rate swap could be used to fix

² IAS 39 paragraphs 74 (b), 96(a)(ii) and implementation guidance F 1.11, F 3.11 and F 5.4

the interest rate on a floating rate debt. Management's main focus may be to ensure that the floating leg of the existing swap and the coupon on the debt continue to offset. Management would be unlikely to consider the impact of the fact that the hedging instrument had a non-zero fair value on designation when assessing the ongoing performance of the hedge.

- ▶ When hedging commodity risk, management may not be able to transact a hedging derivative with exactly the same underlying as the hedged exposure. This may be because the forward market for the hedged exposure is not liquid. In such circumstances, management may focus on the correlation between the spot prices for the hedged exposure and that underlying the hedging instrument.

Following on from our concerns above, consider the following fact pattern. An entity uses a 3 month forward foreign exchange contract to hedge a foreign currency cash flow that is expected to occur in 9 months' time, for the same notional value. It is not clear from the ED which of the possible approaches to assessing and measuring effectiveness and measurement alternatives listed below are acceptable:

- (i) if the spot risk is designated in accordance with paragraph 8b of the ED, is the change in the value of the forward points on the forward contract recorded in profit or loss with no other ineffectiveness being assessed or measured? (This is the current practice under US GAAP and applied by many entities reporting under IAS 39. It helps simplify the accounting and results in all the change in the fair value of the forward points on the hedging instrument being recorded in profit or loss) Or does paragraph B43 require that the changes in the spot prices for the forward contract and forecast cash flow be discounted for measurement purposes, to reflect the six month difference in the time value of money (despite the fact that discounting a spot price has no basis in financial theory)? or
- (ii) if the forward risk is designated, must the change in value of the 3 month contract be compared with that of the 9 month cash flow, which is likely to result in an element of ineffectiveness for measurement and would imply that the hedge ratio may have to be adjusted so as to avoid a 'bias'? or
- (iii) could the 3 month risk be designated as a *component* of the 9 month cash flow, so that effectiveness could be assessed and measured using a 3 month hypothetical derivative? or
- (iv) or would the treatment in (iii) only be appropriate if the entity expects to roll over the 3 month contract and this forms part of its documented risk management strategy? (Or, conversely, only be appropriate if there is no intention to roll over the hedge?) or
- (v) could the *assessment* of effectiveness depend on the entity's risk management strategy (for example, management may decide that the timing of cash flows is irrelevant for the purpose of its assessment of the effectiveness of a foreign currency hedge, so that there would be no requirement to adopt a different hedge ratio for accounting purposes than that used for risk management), while *measurement* may be based on one of the above approaches, depending on whether the spot, or 3 month, or 9 month forward risk is designated for accounting purposes? or
- (vi) is this not an eligible cash flow hedge since the timing of cash flows of the hedging instrument occur before the timing of cash flows of the hedged item?

Another common example is where entities enter into hedging activities where the cash flows on the hedged item and hedging instrument do not coincide, such as the use of long term foreign currency debt as a hedge of next year's foreign currency sales. It is not clear from either IAS 39 or the ED whether this relationship would be eligible for hedge accounting.

We believe that the Board would have an expectation that the present values of the cash flows should ordinarily be considered in assessing hedge effectiveness. However, as demonstrated in some of the examples above, this is not always the case for risk management purposes. If the Board believes that effectiveness assessment must be consistent with risk management strategy, then the wording in the ED should clarify that present values need not always be a key input into the assessment. This is particularly important, given that the effectiveness assessment drives whether rebalancing is required or not. For example, we would not expect the hedge ratio to be adjusted for bias from the unwind of the discounting on the financing element of an off-market swap.

Methods of assessing hedge effectiveness

If the critical terms of the hedging instrument and the hedged item match or are closely aligned, then the ED provides guidance that a qualitative assessment methodology might be acceptable. We support this approach as it avoids the need for unnecessary calculations. However, we note that paragraph B35 of the ED specifies that a qualitative approach is only applicable where it would capture the 'magnitude' of any hedge ineffectiveness. We believe this guidance is part of the confusion on the use of fair values for assessment purposes (discussed above), as it appears that 'noise' from a non-zero fair value derivative on designation is still considered to be hedge ineffectiveness for assessment purposes, but may be ignored if it is immaterial. More importantly, demonstrating eligibility for an exception based on magnitude may be onerous because an entity that performs a qualitative assessment may need to prove that the level of hedge ineffectiveness is less than a defined 'magnitude' and that the magnitude is acceptable in the circumstances.

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?

We are generally supportive of the proposals in the ED, although we have concerns as to the following:

- ▶ the criteria that must be applied in order to decide whether or not a hedge relationship needs to be rebalanced
- ▶ the focus on changing the volume of the hedged item or the hedging instrument as the primary means of rebalancing / eliminating bias.

These are discussed in detail below.

Criteria for rebalancing

It is unclear what criteria must be applied in order to decide whether the output from the hedge effectiveness assessment indicates the need to rebalance the hedge or not.

Paragraph 19(b) appears to indicate that management would need to document their own criteria for passing or failing a hedge effectiveness assessment, and these would then be used in the application of paragraph 23. This interpretation would indicate that management are permitted to apply judgement when deciding whether the level of bias or ineffectiveness is acceptable, or whether they need to rebalance. This interpretation is also supported by paragraphs B33, B38 and B39.

Conversely, paragraph B29 could be taken to mean that the hedge effectiveness objective can only be met if there is no bias and ineffectiveness is minimised. This interpretation could lead to a requirement for frequent rebalancing in order to maintain the hedge effectiveness objective, significantly increasing the operational burden of hedge accounting, resulting in stricter criteria in order to achieve hedge accounting than currently imposed by IAS39.

Frequent rebalancing will increase the operational burden of both cash flow hedging and fair value hedging as follows:

- ▶ For cash flows hedges, each rebalancing adds a new 'layer' of hypothetical derivative. When determining the cumulative change in value of the hedged item and hedging instrument, in order to identify 'the lower of' for accounting purposes, a record must be maintained of all previous designations under each rebalancing and the associated movements in value. It will not be possible just to post the incremental movements for the reporting period in question.
- ▶ For fair value hedges, where there are frequent changes in the volume of hedged item, the fair value movements would need to be amortised and monitored frequently. This is necessary because fair value adjustments will not naturally unwind over time and entities would need to be careful that amounts pertaining to a hedge relationship have been fully amortised by the end of the hedged term.

Given these operational challenges, we would hope that rebalancing is unlikely to be a frequent event for most hedge relationships. Therefore, we would strongly recommend that the Board provides clarity in this area.

Assuming the Board accepts a more judgemental approach to hedge qualification and effectiveness testing (see Appendix II) and given that retrospective ineffectiveness is recognised in profit or loss, we would support the requirement to rebalance a hedge relationship if:

- (a) changes in the value of the hedging instrument are expected to systematically exceed or be less than the change in value of the hedged item; or
- (b) there are other reasons why the accounting hedge relationship is no longer expected to be reasonably effective in offsetting the entity's exposure to the designated risk over the hedged term (eg a significant change in timing of cash flows or basis, as discussed below).

When rebalancing an accounting hedge relationship (as well as for effectiveness assessment, see our response to question 6), we propose that an entity be permitted to apply tolerance levels that are considered acceptable for risk management purposes and also ignore certain sources of ineffectiveness (such as that caused by swaps and forwards with non-zero fair values).

In addition, if an entity's risk management strategy has changed such that the accounting hedge relationship is incompatible with the *revised* risk management strategy, we recommend that it must be terminated. However, if the entity's risk management strategy is relatively high level, so that some proportional de-designations can be made such that the remaining proportion of the existing hedge accounting relationships are compatible with the revised risk management strategy, then this should be permitted. An example would be the de-designation of part of the hedge relationships if there is a change in the risk management strategy from a fixed/floating debt ratio of 60% to 50%. Similarly, where an additional volume of hedge is required to be designated in order for hedge accounting to be compatible with the revised risk management strategy, we propose that the existing hedge relationships need not be terminated (for instance, a change in risk management strategy from a fixed/floating debt ratio of 60% to 70%). This is discussed in more detail in our response to Question 8 on discontinuations.

Having said that, if the Board does not agree with our proposed judgemental approach to effectiveness testing as described in question 6 and Appendix II, then we would strongly urge the Board to permit rather than require rebalancing. Furthermore, if an entity wanted to rebalance in anticipation that the hedge effectiveness assessment might fail in the future, it should be permitted to do so, provided it is also rebalancing for risk management purposes.

Focus on change in volume

The guidance in the ED on rebalancing deals almost exclusively with situations where a change in volume of the existing hedged item or hedging derivative is required. Whilst we agree that such an approach will be appropriate in some circumstances, 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*
On original designation (say, 1 Jan 20X1), a highly probable forecast foreign currency cash flow is expected to occur in 12 months' time (i.e., 31 Dec 20X1). Hence, a forward FX contract for delivery in 12 months' time is transacted and designated within a cash flow hedge relationship. The hedged risk is forward FX risk. It becomes apparent, three months later (on 1 Apr 20X1), that the forecast cash flow will occur 13 months from that point in time (30 Apr 20X2), i.e., four months later than originally expected. At this time the original FX contract has a residual maturity of nine months. Therefore, in order to minimise ineffectiveness from this difference in timing, the entity may transact a forward starting FX swap (near leg nine months, far leg 13 months), creating a synthetic 13 month forward FX contract to match the revised timing of the forecast cash flow and maintaining the risk management strategy to lock in an FX rate for the forecast cash flow. Under the ED, could the forward starting FX swap be included in the hedge relationship as part of rebalancing? Or would the change in forecast cash flow timing mean that the first hedge relationship would need to be terminated and a new one designated?

- ▶ *Change in basis*
A lender provides a loan facility to a borrower such that the borrower may elect to draw funding on a one month basis at 1month LIBOR, or on a three month basis at 3month LIBOR. Historically, the borrower has always drawn down on a one month basis. The lender wishes to lock in a fixed rate for the highly probable loan over the life of the commitment, hence it transacts a receive fixed, pay 1month LIBOR interest rate swap. The swap and forecast drawdowns on the facility are designated within a cash flow hedge, with an expectation of minimal ineffectiveness. Sometime later, the borrower switches its funding from a one month to a three month basis, under the terms of its facility. This will give rise to unexpected ineffectiveness and the lender may wish to transact a one month vs three month basis swap to eliminate that source of ineffectiveness. Under the ED, could the basis swap be designated in combination with the existing fixed v one month swap, to eliminate ineffectiveness from the basis risk as part of a rebalancing? Or would the change in customer behaviour require the end of one hedge designation and the start of another?

It is not clear from the ED whether such changes to hedge relationships are part of rebalancing, or whether rebalancing is relevant only for a change in volume, so that the above scenarios would be treated as a change in risk management strategy. This issue is an example of the problem we raised in response to question 1, as to the level at which a risk management strategy is supposed to operate. If the strategy was to lock in interest rate risk on the loan or FX risk on the cash flow, then, if the entity chose NOT to eliminate the 1month vs 3month risk or the change in timing, that would be inconsistent with the risk management strategy. We believe that rebalancing should not just focus on the changes in volume, but instead encompass a wider range of situations such as a change in the expected timing of cash flows or a change in basis. Accordingly, in our proposals in Appendix II, we write that there may be 'other events' that require rebalancing in order for the hedge to be expected to remain 'reasonably effective'.

Application guidance

The ED does not provide application guidance and it is unclear how entities should apply the requirement to rebalance a cash flow hedge relationship in practice. It is therefore important that the Board clarify its expectations regarding the hypothetical derivative after a rebalancing, so that hedge ineffectiveness can be appropriately assessed and recorded in profit or loss. For example, upon rebalancing a hedge relationship, where additional volume of the hedged item is required, we presume that the hypothetical derivative is now a combination of the original hypothetical derivative (that no longer has a fair value of zero) plus a new derivative at today's market price that has a fair value of zero. Without such guidance, we believe the accounting for rebalancing will be unclear. Guidance similar to that included within the agenda papers when rebalancing was discussed by the Board would be helpful.

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?

Prospective discontinuation

We agree that hedges should be discontinued on a prospective basis when the hedge relationship no longer meets the qualifying criteria. We believe this is appropriate because the ED also permits entities to proactively de-designate proportions of the hedged item, either as part of rebalancing or because a proportion of the hedged item is no longer highly probable.

However, as noted in our response to Question 7, we believe that certain changes to risk management strategy should not automatically result in a full discontinuation. Consider the following changes in risk management strategy for an entity which has USD300m of floating rate debt, but has a risk management strategy that 50% of its debt should be at a fixed rate. Consequently it transacts an interest rate swap for USD150m pay fixed, receive floating and designated it within a cash flow hedge relationship. Imagine three subsequent scenarios:

	Strategy scenario	Impact on existing hedge accounting
(i)	The strategy is amended such that only 40% of the debt is fixed rate. A USD30m pay floating, receive fixed interest rate swap is transacted to reduce the pay fixed position	Proportionally de-designate USD30m of the original hedge relationship. Residual USD120m continues without interruption. De-designated USD30m proportion of original swap and new USD30m swap are both recorded at fair value through profit or loss
(ii)	The strategy is amended such that 60% of the debt should be fixed rate. An additional USD30m pay fixed, receive floating interest rate swap is transacted	Existing USD150m cash flow hedge remains in place. Designate new USD30m swap in a hedge relationship.
(iii)	The strategy is amended such that, over time, 40% of the debt should be fixed and the next 10% hedged with caps. As existing interest rate swaps mature this revised policy is implemented and swaps or options transacted accordingly.	No immediate change to existing hedge relationships, as risk management change is over time.

Voluntary discontinuation

We do not agree with the ED's proposal to preclude voluntary discontinuation if the risk management objective continues to be met. We believe the ED's proposals are inconsistent with the fact that hedge accounting is, in the first place, voluntary. Furthermore, if an entity wanted to discontinue a hedge relationship, it could attempt to close out the derivative and transact a new one or, in extreme circumstances, change its risk management strategy prospectively. Hence the prohibition would seem to be one of form rather than substance. The Board seems to be concerned that entities could abuse the ability to discontinue hedge accounting voluntarily, although continuing with the hedge for risk management purposes, but in our experience entities do not usually choose to expose themselves to profit or loss volatility for no commercial reason. As long as there is no ability to de-designate a hedge retrospectively, the potential for abuse appears to be small.

An entity's risk management objective and strategy may not change, but as other exposures arise, this may change the entity's optimal hedge accounting strategy. For example, an entity issues fixed rate subordinated debt and transacts a swap as part of a fair value hedge. Subsequently it enters into a long term fixed rate asset that it also hedges with a swap. Even though the risk management strategy has not changed, the entity's preference may be to de-designate the original hedge and apply a natural offset for the hedging derivatives to minimise the operational cost of maintaining hedge accounting. In this example, the ED's prohibition on voluntary de-designation means that the entity would be able to cease hedge accounting if it negotiated the cancellation of the hedging instrument, but not if it transacted an offsetting derivative, which seems to be an artificial distinction.

In addition, where risk management activities cannot be designated in a consistent manner for hedge accounting (as we describe in response to question 1), then situations may also arise such that voluntary de-designation is desirable. This could be as other hedge accounting possibilities arise, that are more aligned to the existing risk management strategy. For example, an interest rate exposure may arise in a financial institution's banking book on the issue of 12 year fixed rate debt. As noted previously, although the banking book would ordinarily hedge this with the trading book using a 12 year internal derivative, the trading book may choose to offset this position on a duration basis, or after considering other existing exposures within the trading book such that the external derivative available for hedge accounting will not be a perfect match for the hedged item. Nevertheless the most optimal external derivative will usually be designated for hedge accounting purposes. However, if subsequently an external derivative is transacted within the trading book, which matches the hedged item more closely, the financial institution may prefer to de-designate the original hedge and re-designate using the new derivative. This could all occur without any change to the financial institution's risk management. Also see our concerns in response to Question 1.

Given the various concerns and situations illustrated above, we strongly urge the Board to continue to permit voluntary discontinuation. Although the context is slightly different, we have made a similar recommendation to the FASB. We further recommend that appropriate disclosures be required when entities voluntarily discontinue hedge accounting.

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?

Fair value hedge mechanics

We do not agree with the proposals to recognise the gain or loss on the hedging instrument and hedged item in OCI and transfer the ineffective portion to profit or loss, because this would seem unnecessarily complex. While we agree that the impact of the hedging activity can be reflected in one place in the primary financial statements using such a presentation, we believe that it can be adequately dealt with in a note to the financial statements. It would

never be possible to present all the information useful to users of financial statements in the primary statements.

Also, we do not agree with the proposals in the ED 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, for several reasons:

- i. the primary financial statements may look cluttered, depending on the number of hedge relationships entered into by an entity;
- ii. when hedging a component of the entire item, reflecting the gain or loss attributable to the hedged component in a separate line next to the entire item is not particularly useful; instead, we recommend that the same information is presented in the notes to the accounts, along with the other proposed disclosures;
- iii. the resulting assets and liabilities would not meet the definitions of such items in the *Framework*, especially as there will be hedge adjustments that are negative figures on the assets/liabilities sides of the balance sheet.

In summary, we would support retaining the existing fair value hedge mechanics and requiring the information content of the ED's proposals to be fully reflected in a separate note to the financial statements.

Linked presentation

We agree that linked presentation is not an appropriate solution for fair value hedges. There are a number of arguments for not favouring linked presentation, including the points we have already made concerning the proposed mechanics, balance sheet clutter and the limited value of this information in a primary financial statement. Also, there is no concept of linked presentation elsewhere in the IFRS literature and permitting an exception for this isolated instance would be confusing.

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?

We are pleased that the Board has decided 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.

Paragraph B68 of the ED introduces a new term, 'aligned time value'. This appears to be the time value of a hypothetical derivative, and if so, we would recommend that this wording be used rather than introduce new terminology. We believe that, in most cases, the aligned time value will be the same as the actual time value as it is common practice for the hedging option to be a good match for the hedged item.

The ED's requirement to perform two 'lower of' tests within a cash flow hedge also adds to the complexity - ie., one for the time value and another for the intrinsic value. The guidance in B69 indicates that this comparison should only be performed at inception of the hedge relationship, however, it is not clear whether it must be revisited for forecast hedged transactions when changes to the hedged item occur such that the aligned time value should be amended. For example, if the timing of a forecast hedged transaction were to change, this would affect the aligned time value. Therefore, if there was a requirement to revisit the aligned time value if the timing of a forecast hedged item changes, this could result in a change to the amount that should be amortised part way through the amortisation period, potentially resulting in some form of catch up adjustment. The ED should provide guidance as to how this should be treated.

Paragraph 33(c) of the ED requires that, for time period related options, the unamortised amount accumulated in a separate component of equity (i.e., AOCI) is reclassified to profit or loss immediately upon discontinuation of a hedge, whilst for transaction related hedges the unamortised amount in AOCI is recycled to profit or loss as the hedged item impacts profit or loss. The proposals make intuitive sense for time period related fair value hedges and

transaction related hedges, however, it is less clear why this is the right answer for time related cash flow hedges (such as where options are used to cap a floating rate liability). We recommend that the Board clarifies this in the Standard, with an explanation in the Basis for Conclusions.

We also note that, as worded, the ED's proposals on time value of options do not appear to work for zero cost collars (made up of offsetting caps and floors) since there is no cost to amortise. Accordingly, the time value for such instruments would still need to be recorded at fair value through profit or loss. We believe such a result would not be appropriate, because a collar that had a near zero cost (but actually had an insignificant positive net fair value of say, \$1) would be eligible for the treatment because it would have a "cost" to amortise, whereas any change in time value would need to be recorded through profit or loss if the collar had zero cost. An alternative view is that although there is nothing initially to take to OCI or to amortise (since the instrument has a zero premium), profit or loss volatility can be eliminated for zero cost collars by taking subsequent changes in time value to OCI.

Eligibility of a group of items as the hedged item and Presentation

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?

Whilst we generally agree with the criteria proposed for groups of items as a hedged item, we believe these provisions may have a relatively restricted application.

- ▶ With respect to FX risk, we believe the criteria for designating a net position as a hedged items will generally not be met. Entities hedge net positions based on the timing of cash flows and not based on the timing of the impact on profit or loss.
- ▶ With respect to interest rate risk, most of the important issues relating to hedges of groups of items still need to be addressed in the macro hedging project.

Please see below for further details on the outstanding issues as we see them.

Also, although Introduction paragraph IN7 notes that "the Board has decided not to address open portfolios as part of this exposure draft" and BC20 confirms that the Board only considered closed groups, there is nothing in the ED itself that seems to restrict the

proposals to closed portfolios. Indeed, paragraph B21 states that “a layer component may be specified from a defined, but open, population or from a defined nominal amount”.

The Board should clarify the scope of the proposals and state explicitly whether or not open groups are permitted by the ED, in particular for open portfolio cash flow hedges. If the Board confirms that open portfolios of cash flow hedges are included within the ED itself, we recommend that parts of certain specific IGCs (such as F6.2 and F6.3) from IAS 39 be carried forward to the new standard as application guidance. If the Board intends open portfolios to be dealt with only in the macro hedging project, the wording of the ED will need to be amended.

Macro hedging

Banks and financial institutions typically manage their interest rate risk exposures on a net basis at a portfolio (or macro) level, giving rise to fundamental differences between the requirements in IAS 39 and actual hedging practices. We appreciate that the Board has already commenced deliberating its proposals for this phase of the project. The key issues we would like the Board to consider in its current deliberations on macro hedging are:

- i) *the designation of the bottom layer in a portfolio of prepayable debt instruments.* In this regard, we are pleased that the Board has tentatively decided in November 2010 to consider further the concept of defining the hedged item as the bottom layer of the overall portfolio of prepayable debt instruments. Please also refer to our comments in question 5 on the eligibility of hedging layers of a group of items and the need for a solution for hedging portfolios with prepayment risk.
- ii) *hedges of gross positions, even though risk management is performed on a net fair value basis.* We believe it would be necessary to reconsider the consequences of the general principles developed in the ED for fair value hedges of net positions where both the hedging instrument and the hedged items are remeasured when deliberating any portfolio approach. If such a treatment is applied to macro hedging, this could mean in practice that a bank that hedges its overall net exposure would constantly need to re-measure all of its fixed-rate assets and liabilities. Instead, we recommend that the Board permit the designation of gross positions as eligible hedged items even if risk management is performed on a net fair value basis.
- iii) *the eligibility of demand deposits in a fair value hedge.* There are significant restrictions in the way the fair values of financial liabilities with a demand feature are measured, preventing banks from applying fair value hedge accounting to the majority of their current accounts. Although the Board’s goal for hedge accounting is a better and stronger link with risk management, in this particular case the differences between risk management and hedge accounting are significant. The interest rate risk inherent in demand deposits is typically managed according to their expected withdrawal behaviour, which is normally later than the contractual maturity.

We are encouraged by the fact that the Board is prepared to modify the general hedge accounting model, as necessary, based on its work on the macro hedging model. However, we are also conscious that banks and financial institutions may not be able to comment on the general model without fully understanding the impact of the proposed changes on their existing hedge accounting issues.

Groups of gross positions

For groups of gross positions, if there are no offsetting hedged risk positions within the group, the ED requires that the hedging gains or losses be apportioned to the line items affected by the hedged items on a rational basis i.e., the apportionment should not result in the grossing up of the net gains or losses arising from a single hedging instrument. It would be helpful to clarify whether a similar requirement would extend to where a single derivative is used to hedge different risks. For instance, consider the example of a hedge of a group of foreign currency loans for FX risk and interest rate risk using a cross currency interest rate swap. The fair value of the swap may reflect a gain due to changes in interest rates and a loss due to changes in currency rates. It is not clear if the interest rate gain may be recorded as interest and the FX loss recorded with other FX gains/losses, given this would require grossing up of the net profit or loss on the swap. We recommend that the Board provides guidance on how the hedging gains or losses must be presented in such situations (either as a single line or in different line items).

Groups of net positions - cash flow hedges

We understand the Board's rationale in B75 for avoiding a gross up to hedged items when cash flow hedging is performed on a net basis. In addition, we appreciate that the requirement for hedged items to impact profit or loss in the same reporting period when performing cash flows hedging on net positions is a necessary consequence of this prohibition. However, we note that although the ED permits hedges of net positions for cash flow hedges, the net presentation required by the ED does not provide a significant change from the presentation commonly achieved under IAS39 by non-financial institutions who hedge foreign exchange risk arising from net purchases and sales. Also, many entities will not be able to designate their net position as a hedged item because the two offsetting positions will not affect profit or loss in the same period. It is likely, as a result, that entities will continue to designate their hedges on a gross basis - assuming the proposals in the ED would be amended to allow such a deviation from the risk management strategy (see our response to Question 1).

Groups of net positions - fair value hedges

While we understand why the effect of hedges of groups of net positions should be recorded in a single profit or loss line, we note that this is inconsistent with the treatment of fair value hedges of groups of net positions, which are recorded gross in the balance sheet.

Under the ED, when a group of offsetting items is hedged for fair value risk, all the offsetting items within the group should be re-measured on the balance sheet. Although this does not amount to grossing up the gains or losses on the hedging instrument, it implies that the offsetting hedged items in the group are actually eligible hedging instruments of one another. We believe this is inconsistent with the general eligibility criteria that apply for hedging instruments. For instance, a fixed-rate asset of 100 and a fixed-rate liability of 80 are hedged as a net position with a pay fixed, receive variable interest rate swap of 20. Under the ED, the interest risk component of both the asset of 100 and the liability of 80 will be re-measured in the balance sheet (through OCI with ineffectiveness recorded in profit or loss). This means that, in effect, the asset and the liability are considered as hedging instruments of one another - which creates a significant divergence from the eligibility criteria for hedging instruments and the general accounting requirements for loans and debt instruments. We also believe that this "gross up" of offsetting hedged items could result in significant complexity when applied to a more dynamic strategy as entities would need to keep track of successive re-measurements for numerous items in the balance sheet, as mentioned above in our discussion on macro hedging.

Net positions of currency risk

The guidance on hedges of net positions in the ED (B70-B73) focuses on the hedge of foreign exchange risk where all items within the net position are impacted by the same foreign currency risk. Consequently, we do not believe that the ED envisaged the hedge of a net risk position involving more than one currency. For example, an entity with AUD functional currency expects to have sales of EUR100k in 3 month's time and also expects to have purchases of GBP 90k in 3 month's time. In order to hedge the net FX risk, the entity might transact a sell EUR, buy GBP FX contract. We believe that the existing treatment in IAS 39 should continue, whereby separate hedge relationships for the EUR sales and the GBP purchases would need to be designated. It would be helpful if this was clarified.

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?

Whilst we agree, in principle, with the disclosures proposed in the ED, we are concerned that some of the information required to be disclosed is not appropriate for the financial statements. For example, the ED would require that entities disclose forecast foreign currency denominated purchases or sales over the next three years if the entity applies hedge accounting to any portion/proportion of those cash flows. It is inappropriate for management to have to disclose such forecasts, or for auditors to opine on them. (In contrast, it is possible under IAS 39 for management and auditors to form a view as to

whether a forecast cash flow is *highly probable*, as long as sufficient headroom is built into the estimate to cover uncertainties about the future). If the Board is insistent on requiring disclosures about forecast cash flows, we recommend that they be expressed as a possible range rather than an absolute amount. However, we would question whether this information is very useful and if so, under what circumstances. We note that similar forecast information is not required to be disclosed under any other IFRS and that it is counterintuitive to require entities to disclose future risk exposures which they are hedging but not those which they do not choose to hedge.

In addition, as mentioned under Question 1, we consider that the linkage between an entity's risk management objective and its hedge accounting needs to be better articulated in the ED. We believe that the proposed disclosures should be fine-tuned such that entities are required to explain their risk management strategy, the extent to which it is aligned (or indeed, the extent to which it is different) to hedge accounting and the consequences thereof. In this regard, we note that the illustration provided by the Staff (posted on the IASB website) is a highly granular description of the hedging activities of a simple medium-sized entity. We believe that the level at which risk management strategy is intended by the ED (see our response to Question 1) has an impact on the level of granularity of disclosures. We also believe that the final Standard should provide greater clarity on what is meant by the risk management strategy and objectives and at what level they should be considered. For example, a large corporation may have many different hedging strategies, some of which may be centralised and applied at group level and some of which are decentralised across subsidiaries.

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative

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?

Overall, we support the purpose and direction of the proposed amendments (to the scope of IAS 32) in order to resolve an issue that some IFRS reporters have struggled with for a number of years. However, we are concerned that only a summary of the proposed changes has been included in the Appendix to the ED, and therefore it is not possible to respond properly to the proposals.

It appears that fair value accounting would be 'required' if an entity's risk management strategy is based on fair values. Therefore, there would be no choice for entities that clearly manage their commodity exposure including all own use contracts on a fair value basis. Thus, it would not be possible to apply fair value accounting to only some of the own use contracts,

unless perhaps these are held in different business units and only some are managed on a fair value basis.

Given the foregoing observations, and that there is an accounting policy choice for such contracts under US GAAP, we strongly encourage the IASB to use a similar approach, to permit (rather than require) fair value accounting for own use contracts.

While we are very supportive of the proposed amendments, given the concerns expressed above, we strongly urge the Board to expose for comment (even if it is for a short comment period) the complete wording of the proposed changes, without which there is a risk that not all concerns of constituents will have been addressed.

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 do not believe any of the three alternatives set out in the Basis for Conclusions to the ED is satisfactory. While modifying the fair value option (as set out in the BCs) could be an improvement and will reduce the accounting mismatch in some circumstances, we are concerned that it also creates additional complexities for financial reporting. For example, when economically hedging the credit risk of a fixed rate asset, the volatility of recorded profit or loss could increase by applying the fair value option, as fair value movements from changes in interest rate will also be taken to profit or loss.

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 proposal that the ED should be applied prospectively.

The ED proposes prospective application for annual periods beginning on or after 1 January 2013 with earlier application permitted. However, we note that the results of the Board's consultation on *Effective Dates and Transition Methods*, will have a significant bearing on the timing of the mandatory effective date and transitional relief afforded in IFRS 9. When responding to this consultation, we stated that, as independent auditors, we do not have a

strong preference for either a single date or a sequential approach. We recommended that, if the Board decides in favour of a single date approach, the effective date should be no earlier than 1 January 2015.

Accordingly, if the Board decides to postpone the mandatory effective date for IFRS 9, we recommend that the Board reconsider the transition rules for IFRS 9. Entities that do not early adopt the standard (ie., those that adopt at the mandatory effective date) should be required to use the beginning of the earliest comparative period presented (rather than the beginning of the year in which IFRS 9 is adopted) as the date of initial application for the purpose of classification and measurement. Similarly, entities should be allowed, but not required, to designate their IFRS 9 hedge relationships in parallel with their IAS 39 hedge relationships (and without the benefit of hindsight) so as to permit restatement of comparative information.

Appendix II - Proposed wording to articulate the link between risk management, hedge accounting and effectiveness testing

1A Entities may alter the pattern of recognition of gains and losses arising from assets and liabilities carried at fair value from their risk management activities, only if they comply with the hedge accounting requirements of IFRS 9

Qualifying criteria for hedge accounting

19. A hedge relationship qualifies for hedge accounting only if all the following criteria are met:

- (a) The accounting hedge relationship consists only of eligible hedging instruments and hedged items.
- (b) At the inception of the hedge there is formal designation and documentation of the accounting hedge relationship and the entity's risk management strategy for undertaking the hedge.
- (c) The accounting hedge relationship is designated so as to be compatible, as far as is possible, with the risk management strategy, with differences being restricted to those necessary to comply with the qualifying criteria for hedge accounting. The accounting hedge relationship should be designated so as to most faithfully represent the risk management strategy.
- (d) The hedge documentation includes identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the accounting hedge relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio).
- (e) The accounting hedge relationship meets the objective of the hedge effectiveness assessment (see paragraphs B27-B39).

B 29: The objective of the hedge effectiveness assessment is to ensure that the accounting hedge relationship is expected to be reasonably effective in offsetting the entity's exposure to the designated risk over the hedged term (ie the life of the hedge relationship). This includes an expectation that:

- i) the changes in the value of the hedging instrument will not systematically exceed or be less than the change in value of the hedged item ; and that
- ii) an economic relationship exists between the hedging instrument and the hedged item.

B29 A However, this does not mean that the hedging relationship has to be expected to be perfectly effective in order to qualify for hedge accounting. In its assessment, the entity need not consider:

- a. ineffectiveness within tolerance levels considered acceptable for risk management purposes; and
- b. the sources of ineffectiveness measured for accounting purposes, that are considered irrelevant for the purposes of the risk management strategy, such as that caused by

swaps and forward contracts having a non-zero fair value, or by changes in the credit risk associated with the counterparty to the hedging instrument as long as that counterparty is expected to perform its obligations.

B29 B Actual ineffectiveness that arises during the reporting period must be considered in making the hedge effectiveness assessment, but may be disregarded if the hedging relationship is still expected to be reasonably effective over the hedged term.

Rebalancing

B47 An entity must rebalance the accounting hedge relationship in each of the following situations:

- (a) changes in the value of the hedging instrument are expected to systematically exceed or be less than the change in value of the hedged item, or
- (b) there are other reasons why the accounting hedge relationship is no longer expected to be reasonably effective in offsetting the entity's exposure to the designated risk over the hedged term (eg because of a significant change in the timing of cash flows).

When rebalancing an accounting hedge relationship, an entity may ignore certain sources of ineffectiveness and apply the tolerance levels as set out in B29A. Nevertheless, at any point in time, an entity may proactively rebalance an accounting hedge relationship to make it more effective.

B47A Rebalancing is accounted for as a continuation of the accounting hedge relationship in accordance with B48-60. Upon rebalancing, any hedge ineffectiveness of the accounting hedge relationship up to the date of rebalancing is determined and recognised in profit or loss immediately before adjusting the accounting hedge relationship.

B64 An accounting hedge relationship, or a portion thereof, is discontinued when:

- (a) the risk management strategy has changed such that the accounting hedge relationship, or a portion thereof, is no longer compatible with the risk management strategy;
- (b) the hedging instrument or instruments have been sold or terminated; or
- (c) there is no longer an economic relationship between the hedging instrument and the hedged item.; or
- (d) even with rebalancing, the hedge relationship is no longer expected to be reasonably effective.

The following flowchart provides a high level outline of our proposals above in respect of rebalancing and termination of hedge relationships.

Rebalance or terminate ?
 (subsequent to inception of hedge relationship)

