



April 25, 2011

Ms. Leslie F. Seidman, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 2011-175; Discussion Paper — *Selected Issues about Hedge Accounting*

Dear Ms. Seidman:

Citigroup appreciates the opportunity to comment on the Discussion Paper — *Selected Issues about Hedge Accounting* (the Discussion Paper, DP, or the IASB's proposal).

Citigroup strongly supports full convergence of IFRS and U.S. GAAP, in particular on the accounting for financial instruments, and we commend the Boards for their efforts to achieve convergence in this critical area. Convergence should remain a priority, and we urge the FASB and IASB to work together to finalize the hedge accounting guidance, as well as the other parts of the financial instruments project, in order to eliminate the differences in their models and to issue fully converged standards.

We are supportive of the IASB's proposal to issue a more principles-based hedge accounting model that would remove many unnecessary restrictions relating to hedged items and hedging instruments present in the hedge accounting guidance today. However, we are concerned about the proposed model's assumption that hedge accounting would cover *all* risk management activities. The purpose of a hedge accounting standard should be to increase the usefulness of hedge accounting as a risk management tool, rather than linking hedge accounting directly to risk management or vice versa. Risk management strategies are applied more broadly and most of the time require no hedge accounting designation.

Furthermore, we are concerned that the IASB's proposal, through its restrictiveness and reliance on documented risk management objectives for hedge effectiveness testing and dedesignation, would actually fail to properly reflect in the financial statements the principles of risk management strategies employed by financial institutions. For example, while risk management might tolerate some ineffectiveness, the rules surrounding rebalancing of hedge accounting

relationships, in addition to being unnecessarily complex and very difficult to apply in practice, would require entities to rebalance hedges quarterly. Such actions are usually not necessary from an overall risk management perspective. Also, a decision to dedesignate a hedge is not inconsistent with risk management as the entity may have decided to use tools outside of hedge accounting as its application of the same risk management strategy continues. Since risk management is not applied on an individual instrument basis, hedge dedesignations cannot depend on risk management objectives, especially at the individual instrument level.

As such, the IASB's proposal, while being a strong step forward in some areas, requires significant improvements before the proposed model can be finalized. We ask that the Boards integrate some of hedge accounting-related proposals from the FASB's Exposure Draft (ED), *Accounting for Financial Instruments*, into the final converged hedge accounting model.

Additional detail can be found in our responses on the specific questions outlined in the Discussion Paper, included in the following Attachment 1. We have also enclosed our comment letter on the Exposure Draft, *Hedge Accounting*, that we submitted to the IASB in March, as Attachment 2.

We would be pleased to discuss our comments with you at your convenience. Please contact me at 212-559-7721.

Sincerely,



Robert Traficanti
Deputy Controller and Global Head of Accounting Policy

Cc: Sir David Tweedie, Chairman
International Accounting Standards Board
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United Kingdom

Attachment 1**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 are concerned that the IASB's ED fails to acknowledge the differences between risk management and hedge accounting since it is not clear whether the ED assumes that hedge accounting under the new proposed approach would cover *all* risk management activities or just those that an entity has decided to manage by applying hedge accounting. Hedge accounting can only represent a portion rather than the entire risk management of a reporting entity. The role of hedge accounting, which is based on management's election, is to help align the accounting treatment with *certain* risk management activities of the reporting entity, and reflect the economics of those risk management activities where the accounting rules for the specific instruments would otherwise create an accounting mismatch.

It is not possible to align hedge accounting rules with all risk management activities because risk management is a much broader concept. Risk management can be performed at many different levels of an organization. For example, the risk management and risk tolerances for a specific "desk" or business within a financial institution may be different than the overall objectives and strategies for the regulated legal entity, segment, or consolidated group (see our letter to IASB for more detail). Since the focus of the IASB's ED (or hedge accounting guidance within the FASB's ED, *Accounting for Financial Instruments*) should be hedge accounting, we believe the Boards should try to ensure the guidance would require entities to provide useful information about hedge accounting rather than attempting to cover all risk management activities.

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?

The IASB's ED is not at all clear about what is meant by risk management. Therefore, it is not possible under the ED to understand how to apply the risk management notion at a hedging transaction level or to determine the level of required documentation for risk management activities.

However, we believe the ED does not need additional clarity regarding what is meant by risk management or how risk management is documented and applied at a transaction level, because that should be outside the scope of the guidance for hedge accounting. Rather, the ED should clarify that, consistent with today's requirements, the hedge documentation should relate to an entity's ability to elect hedge accounting for a particular transaction that qualifies under a defined hedging strategy (which is consistent with risk management), rather than requiring entities to document all risk management activities and then allowing hedge accounting only if it is based on any of those documented strategies. While we agree that the principles of hedge accounting and the determination of which transactions could be subject to a hedge accounting election should be aligned with the underlying economics of how risk management activities are conducted in general,¹ we strongly object to the notion that an entity's documented risk management strategies should form a basis for electing (or being able to terminate) hedge accounting.

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?

The IASB does not specify in the ED the required level at which the risk management objective and strategy should be documented or hedge accounting applied. We believe it would be very challenging to do so because risk management is performed at many different levels of an organization. Moreover, the risk management activities of an organization are not currently documented consistent with hedge accounting strategies at the consolidated entity level. If the ED were to require that hedge accounting elections must be based on a specific risk management objective, or at a specific level within the organization, entities would have to start documenting such objectives solely for the purpose of achieving hedge accounting. However, as stated above, we believe such a requirement is unnecessary as risk management should not be directly tied to hedge accounting rules.

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?

¹ For example, entities should be able to apply hedge accounting to manage credit risk since, due to their significant exposure to credit risk, managing such risk is one of their primary risk management objectives.

Please see our responses to questions 1, 2 and 3 above. While the disclosures about the various risks that entities are exposed to and how the company manages such risks are already made in the Management's Discussion and Analysis section of their annual reports, we believe that the proposed linking of risk management to hedge accounting in the ED creates significant audit difficulties. For example, the proposal requires constituents to demonstrate that the risk management strategy has changed in order to be able to dedesignate a hedge accounting relationship. In effect, our auditors may need to opine on our risk management strategies in order to be able to conclude whether such dedesignation was appropriate. We believe that risk management objectives should not be subject to the auditor's opinion.

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 agree in principle, but think the number of applications of designating a cash instrument as a hedging instrument will be limited. We agree that, if cash instruments are allowed as hedging instruments, additional rules are needed around when such designation is allowed in order to prevent entities from using hedge accounting to circumvent classification and measurement, impairment, or any other accounting guidance to which those cash instruments may otherwise be subject.

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?

Citi has no comments.

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 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 attributable to a specific risk or risk component. We also agree with the criterion that in order to be able to designate a risk component, it should be separately identifiable and reliably measurable. Such criteria seem sufficient if the Boards intend to issue a principles-based standard.

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

We believe that “separately identifiable” should not be limited to contractually specified risk components. Hedge accounting guidance today already allows designation of some non-contractually specified risk components (for example, hedging the LIBOR component in a fixed-rate debt instrument). Those hedges are very common and have worked well in practice. Therefore, we do not see why hedge accounting should be limited only to risk components that are contractually specified and recommend that the final principles-based standard permit hedging of risks in line with common risk management strategies, which may include hedges of risks that are not contractually specified.

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?

Hedge accounting rules today do not allow fair value hedging to be applied to a defined but open population of hedged items. For cash flow hedges, the hedged layer in an open population must be identified as the first units after, and not as the last units before, a certain prespecified date(s). The reasoning behind such requirement is that, since the hedged forecasted item must be identified in advance, allowing the last items to be specified as hedged would mean that the specific identification would occur retrospectively. We believe that this logic is conceptually sound and should be carried forward into the new standard dealing with hedge accounting.

We look forward to the more detailed guidance from IASB on macro hedging.

Please see our response to Question 5 in the comment letter to the IASB.

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 support the proposal to allow hedging of aggregate exposures in principle, but believe that further clarification is needed regarding accounting models that would apply to the aggregated instruments. Without further guidance, we do have operational concerns as it is not clear how other guidance in IFRS or U.S. GAAP (e.g., classification and measurement, impairment, interest income recognition, etc.) would apply to these aggregated exposures.

For example, assume a reporting entity owns a 10-year fixed-rate bond accounted for at amortized cost, and enters into an interest rate swap for the entire 10 years (pay fixed, receive floating). Furthermore, assume that the reporting entity wants to fix its interest receipts for the first 2 years, and therefore executes an interest rate swap with a 2-year tenor (receive fixed, pay floating). The IASB's ED would permit the reporting entity to designate the aggregated 10-year bond and 10-year interest rate swap as an exposure that is eligible for hedge accounting. It is not clear in the ED, however, whether the bond and 10-year swap should be accounted for as a synthetic floating-rate instrument, at amortized cost, or under the usual hedge accounting models. We note that certain publications commenting on the ED have stated that the combined synthetic instrument accounting may be the IASB's intended result. Also, if combined synthetic instrument accounting is initially applied, it is not clear in this example what the accounting should be for the combined instrument (10-year bond and 10-year swap) after the 2-year hedge expires. Assuming that the entity decides not to hedge the combined instrument after the first 2 years, we assume that the combined instrument would then have to be broken up and appropriate accounting applied on an individual instrument basis. The 10-year interest rate swap with 8 years then remaining would be subject to fair value accounting, resulting in an earnings adjustment from amortized cost to fair value. Such a financial statement impact resulting from the expiration of the 2-year hedge seems very counterintuitive.

In our view, each derivative should be accounted for using the standard hedge accounting models, and derivatives should always be measured at fair value. The 10-year swap would be designated in a fair value hedge of interest rate risk, the 2-year swap would be designated in a

cash flow hedge of interest rate risk, and the bond would be remeasured for changes in fair value due to changes in the relevant interest rate. The Boards should clarify this in the final standard to ensure applicability and consistency in practice.

Please see also our response to Question 3 in the comment letter to the IASB.

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?

As discussed in our previous response, we believe more guidance is needed on aggregated exposures in order to be able to say whether such guidance would help or hurt the transparency or consistency of information about an entity's use of derivatives.

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?

The guidance provided in the IASB's ED allows items to be grouped only if they are risk-managed on a net basis as a group. We are concerned that this requirement, like the rest of the ED, puts too much emphasis on risk management strategy to determine an accounting result. Risk management strategies may change frequently and it is not clear whether an entity manages its risks related to a particular group on a net or gross basis at a given point in time. Furthermore, it should not matter, because it is the total net exposure to a risk that entities ultimately need to manage. Does that mean that any instrument through which an entity is exposed to the same type of risk can be included in a group of hedged items (according to the ED, whether an entity hedges on a gross or net basis is a matter of fact, not assertion or documentation)? We are greatly concerned about this guidance. As stated earlier in this letter, while the principles of hedge accounting and the determination of which transactions could qualify for hedge accounting election should be aligned with how risk management activities are conducted in general, we disagree that risk management should be directly tied to hedging rules and determine an accounting result.

Furthermore, while we support in principle the proposal to allow hedging of the net exposure in a group that is composed of offsetting cash instruments, we have similar concerns about the applicability of other guidance in IFRS or U.S. GAAP to groups of assets and/or liabilities for aggregated exposures as discussed in response to Question 11 above. We ask that more guidance be provided in this area.

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?

Overall, we believe that the effectiveness requirements in the ED should be replaced with a qualitative analysis to demonstrate that the relationship provides an economic offset between the hedged item and hedging instrument. This qualitative analysis to demonstrate that the relationship provides an economic offset was introduced in the earlier hedge accounting proposal from the FASB, which we believe is superior in terms of the assessment of effectiveness to the new concepts introduced in the IASB's ED.

We believe that the "other-than-accidental offset" portion of the IASB's effectiveness assessment proposal would be similar to the FASB's qualitative analysis to demonstrate that the relationship provides an economic offset. Therefore, we do not have any significant concerns about that aspect of the IASB's hedge effectiveness assessment proposal. However, we disagree with other pieces of the effectiveness assessment model proposed by the IASB. Please see our comments in response to Questions 16 and 17 and responses to Questions 6 and 7 in our comment letter to the IASB.

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?

We are very supportive of the effort to simplify the assessment of hedge effectiveness by allowing a qualitative effectiveness assessment to be performed only on a prospective basis. As actual ineffectiveness will be recorded in earnings on a retrospective basis, the requirement to assess hedge effectiveness only prospectively seems logical.

However, we believe the guidance and illustrative examples provided in the IASB's ED are insufficient to understand how the proposed requirements regarding the assessment of hedge effectiveness need to be applied. We ask that illustrative examples be provided to demonstrate the assessment of hedge effectiveness with respect to an "entity's risk management [as] the main source of information to perform the effectiveness" test (paragraph B38), determining the point at which a hedging relationship would no longer be considered effective, and circumstances in which hedge rebalancing vs. dedesignation is required.

Additionally, regarding guidance for measurement, we support the IASB's proposal to allow the use of a hypothetical derivative method for fair value hedges. Today such a method is available only for cash flow hedges. The availability of hypothetical derivative method would be

particularly useful in significantly reducing complexity in such common fair value hedging strategies as interest rate hedges of fixed-rate issued debt.

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?

Citigroup supports removing the 'bright line' rules for hedging ratios from the effectiveness criteria, commonly referred to as the 80-125% test. We also agree that effectiveness testing should be consistent with the entity's general risk management activities, which may tolerate some hedge ineffectiveness.

However, we have significant concerns with the IASB's proposed hedge effectiveness assessment requirement. In particular, we think that the proposal to require entities to prove that the risk management objective has changed in order to dedesignate a hedge accounting relationship is not operational or auditable. In practice, hedge accounting must be elective because it is not possible to prescribe with specificity how risk management activities must be aligned with hedge accounting. We believe that accounting rules should not be directly tied to risk management objectives.

The IASB's ED does not specify the level at which the 'risk management objective and strategy' should be documented or hedge accounting applied. Should the risk management objective be defined at the individual hedge relationship level or hedge program/risk strategy level? If it is defined at the individual hedge relationship level, then a company would always be able to dedesignate a hedge as long as it can argue that the risk management objective for that particular hedging relationship has changed. Conversely, if the risk management objective is applied at the hedge program/risk strategy level, a company may never be able to dedesignate an individual hedging relationship unless the entire hedging strategy is terminated. For common types of hedging strategies used by banks, such as interest rate hedges, the latter approach would effectively mean constant rebalancing and no dedesignations ever. This is true even if the bank wants to designate a hedging relationship to better manage overall interest rate exposure. Since risk management strategies are applied more broadly rather than on an individual instrument basis, reliance on risk management for hedge accounting results would create significant operational and implementation issues.

Also, risk management is performed at many different levels of management. As discussed in response to Question 1 above and our comment letter to IASB, the risk management and risk

tolerances for a specific “desk” or business within a financial institution may be different than the overall objectives and strategies for the regulated legal entity, segment, or consolidated group. Similar issues apply to corporate entities. The IASB appears to acknowledge that there are difficulties in this area when referring to discussions of whether disclosures should be required for economic hedges (i.e., those contracts which mitigate risk, but which are not subject to hedge accounting) in BC205-207 of the Basis for Conclusions. The relevant paragraphs state that it would be difficult to determine “which part of an entity’s risk management was relevant for the purpose of this disclosure and then define this part to make the disclosure requirement operational. The Board did not believe that this was feasible as part of its hedge accounting project but would have a much wider generic scope.” We note that this difficulty is not restricted to economic hedging and disclosures, but is equally applicable to those risk management activities which are eligible for hedge accounting.

Given that this disparity will continue to exist between risk management strategies and accounting, we ask that hedge designations be based upon an accounting decision within the framework of the overall risk management strategy, rather than to reflect a specific risk management objective. This would reduce the complex proposals regarding dedesignation and rebalancing that we believe would give rise to many implementation issues and reduce consistency of application in practice. Furthermore, we ask that hedge dedesignations continue to be voluntary without significant restrictions. Current U.S. GAAP and IFRS hedge accounting guidance in this area permits voluntary dedesignations and has not caused issues in practice.

Please also refer to our following response and responses to Questions 6 and 7 in our comment letter to the IASB.

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?

The proposal regarding the potential need to rebalance a hedging relationship to continue to qualify for hedge accounting is not clearly expressed in the ED and may create very significant operational issues. Citigroup believes that the mandatory rebalancing requirement should be removed from the final standard.

In particular, we question what benefit a compulsory rebalancing would have for the reporting entity in a simple hedging relationship scenario such as debt hedged for interest rate risk with matching notional amounts. For any hedge where the terms of the hedged item and hedging instrument match perfectly or very closely, a qualitative assessment without the requirement to rebalance the hedge should be sufficient despite some ineffectiveness that is expected to occur

due to the differences in measurement of the hedged item and hedging instrument. Although the ED explicitly allows qualitative effectiveness testing in certain cases, we do not understand how qualitative assessment can ever be applied if the effectiveness test is based on the quantitative hedge ratio that is always expected to minimize hedge ineffectiveness.

Moreover, it is unclear how the rebalancing requirement would align with the overall risk management objectives of the reporting entity. In practice, risk management strategies often are expressed with broad parameters, for example, that an entity should maintain interest rate risk within a certain range. Should rebalancing be required, we are concerned that the accounting literature will require an entity to start adjusting hedges quarterly to meet the hedge accounting rules, rather than an actual risk management objective or business requirement. Such a hedge ratio may minimize expected hedge ineffectiveness on each assessment date, but would significantly increase the overall cost for an entity to apply hedge accounting.

Should the rebalancing requirement be retained, we request that further implementation guidance be provided to enforce a consistent differentiation between ineffectiveness being present in the relationship, but the relationship still achieving a reasonable hedging ratio as determined in the risk management strategy, versus persistent ineffectiveness which could require rebalancing.

Furthermore, since the ED currently seems to require rebalancing for every hedging relationship each period which may have not been the IASB's intent, we ask that the Boards articulate more clearly the circumstances in which a rebalancing is actually required. Questions that we believe need to be addressed include:

- Is the Boards' intent that only significant and persistently high levels of ineffectiveness should trigger a rebalancing? Alternatively, what level of nominal ineffectiveness or other 'normal' changes in the statistical relationship between the hedged item and the hedging instrument would require rebalancing of the hedge? Can the Boards provide explicit guidance which will allow entities to determine what would constitute a nominal level of ineffectiveness?
- If a reporting entity fails to rebalance a hedging relationship, does that trigger the loss of hedge accounting and potential restatement risk? It is not clear what processes should be followed if the hedging ratio is not rebalanced in such an instance (for example by purchasing a new derivative). Would there be a requirement to rebalance for accounting purposes only? Or would the act of not rebalancing effectively lead to a de-designation event (i.e., voluntary de-designations by proxy)?

- Can a qualitative analysis ever truly be sufficient, given that rebalancing is required to reach the “optimal” hedging ratio? Should the final standard provide a specific definition of what would qualify as “optimal”?
- The examples in the ED are focused on *quantity* and not, for example, timing. Would a change in the estimated date of a forecasted transaction require rebalancing so that the maturity date of the derivative, for example, would have to be amended?

Please also refer to our previous response and responses to Questions 6 and 7 in our comment letter to the IASB.

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?

Citi has no comments.

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?

While we do not object to this proposal, we do not believe that recording the changes in value of both the derivative and the hedged item in OCI rather than income for fair value hedges improves the usefulness of information for the user of the financial statements. Since any difference between the two OCI amounts represents ineffectiveness that has to be transferred to profit or loss, the two amounts remaining in OCI must be the same and will net to zero.

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 believe the separate presentation of the basis adjustment would significantly increase the transparency or usefulness of the information about an entity’s hedging activities. We are also concerned that the basis adjustment, which is required to be presented as a separate line

item on the balance sheet, does not meet the definition of either an asset or a liability. Furthermore, there are significant practical concerns about tracking which balances are recorded within such an account at a financial institution like Citigroup where hedge accounting is used extensively. There are currently no systems in place which could track or monitor such a balance on an ongoing basis. Citigroup recommends that the hedge adjustment not be required to be presented as a separate line item and the final standard carry over the existing requirements of U.S. GAAP and IFRS in this area.

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?

Please see our previous response. We have significant concerns about tracking which balances are recorded within the separate line item and adjusting the line item related to basis adjustment if the composition of the group of hedged assets and liabilities changes during the hedge term. We therefore ask that the hedge adjustment not be required to be presented as a separate line item.

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?

We believe that the proposed linking of risk management to hedge accounting and the inclusion of risk management disclosures in the notes to the financial statements creates significant audit difficulties as the auditors would be required to opine on our risk management strategies. Risk management activities should be kept outside the scope of a financial audit, which requires auditors to review and issue an opinion on whether financial statements of a company are relevant, accurate, complete, and fairly presented in accordance with the relevant accounting standards. Risk management is the responsibility of company's management and the sufficiency of such activities should not be subject to the auditor's opinion.

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?

The FASB's ED on Financial Instruments proposed fairly limited changes to hedge accounting whereas the IASB's ED proposes a much broader re-examination of hedge accounting, covering hedging of both financial and nonfinancial exposures. We believe the FASB and IASB should converge their respective approaches by taking certain elements from each of the proposals.

We support the following aspects of the IASB's approach:

- Issuance of a more principles-based standard that would simplify and align hedge accounting with the underlying economics of hedging as a risk management tool.
- Broadening the scope of hedged items to include separately identifiable and reliably measurable risk components that are part of financial or non-financial items (including credit risk and prepayment risk, if separately identifiable and reliably measurable). Please see our response to Question 4 in the comment letter to the IASB.
- While we also support in principle the ability to designate aggregated exposures and net positions as hedged items, and cash instruments as hedging instruments, we believe additional rules are needed about when such items can be designated in order to prevent entities from using hedge accounting to circumvent classification and measurement, impairment or any other accounting guidance to which those instruments may otherwise be subject.
- Recording of time value in OCI, rather than immediately in earnings, for hedges that utilize options as hedging instruments.
- Removing the "bright line 80-125%" test for hedge the effectiveness assessment and replacing it with a forward-looking assessment.

However, we strongly object to the IASB's proposed rebalancing of hedges each period to achieve a ratio that minimizes expected ineffectiveness and limiting the ability to dedesignate hedges based on documented changes in risk management objectives.

We support the FASB's provisions in the Financial Instruments ED requiring hedges to be reasonably effective rather than highly effective, and a qualitative effectiveness assessment instead of the current quantitative assessment. We believe a qualitative demonstration of an economic relationship between the hedging instrument and the hedged item at hedge designation is sufficient to support effectiveness and is more consistent with a principles-based approach. For example, if a hedge that is expected to be well within the "reasonably effective" range because the terms of the hedging instrument and the hedged items have been closely matched at inception, no further assessment in subsequent periods should be necessary other than the hedging unit's determining that those terms have not changed. Absent a contractual or other fundamental change to the hedging instrument or hedged position which could result in

there no longer being an economic relationship, the company's original risk management objective is unaffected and hedge accounting should continue without any further quantitative effectiveness evaluation. These types of changes will serve to reduce complexity in this currently very complex area.

However, we fail to understand why the FASB and IASB would not allow voluntary hedge dedesignations. Dedesignation and redesignation of hedge relationships reflects the dynamic nature of hedging as a prudent risk management practice. Prohibiting dedesignation only limits management's ability to manage risks through changing economic environments and balance sheet composition. We ask that hedge dedesignations continue to be voluntary without significant restrictions.

Attachment 2

9 March 2011

International Accounting Standards Board
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United Kingdom

Re: Exposure Draft: Hedge Accounting ED/2010/13

Citigroup appreciates the opportunity to respond to the Exposure Draft: *Hedge Accounting* (ED or the proposal). Overall, we are supportive of the IASB's proposal to better represent the risk management activities of the reporting entity in the hedge accounting models. However, we have concerns that the ED presents a hedge accounting model which is too restrictive to be able to properly reflect in the financial statements many common risk management strategies employed by financial institutions. The rules surrounding de-designation and rebalancing of hedge accounting relationships are unnecessarily complex and restrictive and will be very difficult to apply in practice. As such, the proposal, whilst being a strong step forward in many areas, does not achieve its stated objectives. Our further comments are outlined in greater detail through responses to the specific questions raised in the ED.

Citigroup strongly supports full convergence of IFRS and U.S. GAAP, in particular on the accounting for financial instruments. Convergence should remain a priority, and we urge the IASB and FASB to work together to finalize the hedge accounting guidance.

We would be pleased to discuss our comments with you at your convenience. Please feel free to call me in New York at (212) 559-7721.

Sincerely,

A handwritten signature in blue ink that reads "Robert Traficanti".

Robert Traficanti
Deputy Controller and Global Head of Accounting Policy
Citigroup Inc.

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 in principle with the overall objective of hedge accounting “to represent in the financial statements the effects of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss.” However, we are concerned that this objective fails to acknowledge the differences between risk management and hedge accounting. Hedge accounting only represents a portion rather than the entire risk management of a reporting entity. The role of hedge accounting, which is based on management’s election, is to help align the accounting treatment with certain risk management activities of the reporting entity, and help reflect the economics of those risk management activities where the accounting rules for the specific instruments would otherwise create an accounting mismatch. We have two primary comments where the proposals in the Exposure Draft do not meet the objectives and should be amended.

Certain Restrictions on Hedge Accounting are Inconsistent with the Objectives

As currently drafted, the proposal contains too many restrictions to represent adequately many common risk management practices of financial institutions. We believe that the model should be fully principles-based and permit hedging strategies which are widely used in the risk management practices of reporting entities, but which are not currently accepted in the accounting literature. In particular, the ED takes the view that credit risk is not a separately identifiable or reliably measurable risk and thus is not eligible for hedge accounting. Many financial institutions use Credit Default Swap (CDS) contracts to manage the credit risk of loan assets held on balance sheet. Credit risk is clearly a component risk within loan exposures, and the primary purpose of the derivative trades is to manage risk in the loan book. Credit risk is currently isolated, measured, and (for many U.S. GAAP reporters) separately disclosed for derivatives and debt instruments accounted for at fair value (commonly referred to as credit valuation adjustments (CVAs) for counterparty and own credit non-performance risk). Since financial institutions can and are required to separately disclose CVA on complex derivatives and structured notes, it is possible to isolate credit risk on most loans. As such, we believe that credit exposures in loan books are separately identifiable and reliably measurable and should be eligible within this framework as hedged items. We would compare this with, for example, a hedge of crude oil prices as a component in the pricing of jet fuel, which the ED explicitly permits although similar valuation judgments are necessary.

More fundamentally we think the final model should permit judgment in this area and not explicitly permit or prohibit certain hedging strategies. Using a principles-based approach, there will be less need for specific exceptions (for example, those discussed in BC226 for hedges of credit risk) which only serve to further complicate an already complex area. Refer to Questions 4 and 15 for more details.

Hedge Accounting Dedeignation Should be Elective

The proposal to require constituents to prove that the risk management strategy has changed in order to dedesignate a hedge accounting relationship is not operational or auditable. Current IAS 39 hedge accounting guidance in this area permits voluntary dedesignation and has not caused issues in practice.

In practice, hedge accounting must be elective because it is not possible to prescribe which risk management activities must be aligned or tied to hedge accounting. The Board does not specify in the ED the required level at which the ‘risk management objective and strategy’ should be documented or hedge accounting should be applied. We do not believe it would be possible to do so, because risk management is performed at many different levels and is not (and should not be) directly tied to accounting rules. The risk management and risk tolerances for a specific “desk” or business within a financial institution may be different than the overall objectives and strategies for the regulated legal entity, segment, or consolidated group. Similar issues arise for corporate entities. The Board appears to acknowledge that there are difficulties in this area when referring to discussions of whether disclosures should be required for economic hedges (i.e., those contracts which mitigate risk, but which are not subject to hedge accounting) in BC205-207 of the Basis for Conclusions. The relevant paragraphs state that it would be difficult for the Board to determine “which part of an entity’s risk management was relevant for the purpose of this disclosure and then define this part to make the disclosure requirement operational. The Board did not believe that this was feasible as part of its hedge accounting project but would have a much wider generic scope.” We note that this difficulty is not restricted to economic hedging and disclosures, but is equally applicable to those risk management activities which are eligible for hedge accounting.

Given that disparity will and must continue to exist between risk management strategies and accounting, we would request that the objective of hedge designations be based upon an accounting decision within the framework of the overall risk management strategy, rather than simply to reflect the overall risk management strategy. This would better marry the objectives of the ED with the current proposals contained therein. It would also reduce the exceedingly complex proposals around de-designation and rebalancing that we believe will cause countless implementation issues and reduce consistency of application in practice.

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 in principle but think the practical applications of this will be limited.

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 strongly support this proposal in principle, but request further clarification to explicitly state the accounting models which should be applied to the aggregated instruments. For example, assume a reporting entity owns a 10-year fixed-rate bond accounted for at amortized cost, and enters into an interest rate swap for the entire 10 years (pay fixed, receive floating). Further assume that the reporting entity wants to fix its interest receipts for the first 2 years, and therefore executes an interest rate swap with a 2-year tenor (receive fixed, pay floating). The ED would permit the reporting entity to designate the aggregated 10-year bond and 10-year interest rate swap as an exposure that is eligible for hedge accounting.

It is not clear in the ED, however, whether the bond and 10-year swap should be accounted for as a synthetic floating-rate instrument, at amortized cost, or under the usual hedge accounting models. We note certain publications commenting on the ED state that combined synthetic instrument accounting may be the Board's intended result. Also, if combined synthetic instrument accounting is initially applied, it is not clear in this example what the accounting should be for the combined instrument (10-year bond and 10-year swap) after the 2-year hedge expires. Assuming that the entity decides not to hedge the combined instrument after the first 2 years, we assume that the combined instrument would then have to be broken up and appropriate accounting applied on an individual instrument basis. The 10-year interest rate swap with 8 years then remaining would be subject to fair value accounting, resulting in an earnings adjustment from amortized cost to fair value. Such a financial statement impact that would occur as a result of the expiration of the 2-year hedge seems very counterintuitive.

In our view, each derivative should be accounted for using the standard hedge accounting models, and derivatives should always be measured at fair value. The 10-year swap would be designated in a fair value hedge of interest rate risk, and the 2-year swap would be designated in a cash flow hedge of interest rate risk. The Board should clarify this in the final standard to avoid unnecessary misunderstandings or lack of consistency in practice.

Question 4

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

We agree with this principle. Citigroup particularly supports that this model will permit hedge accounting for many common risk management strategies for non-financial commodity exposures. However, hedges of credit risk remain challenging (restricted) under these proposals, and we do not understand why credit risk continues to be singled out for special onerous treatment. We do not agree with the Board's assertion that measuring the credit risk component of a loan or a loan commitment is overly complex. There appears to be a conceptual difference in the model proposed to be applied to financial instruments versus non-financial instruments. In a principles-based standard, we do not understand why such a distinction is necessary. For example, inflation is not an eligible hedged risk in financial instruments unless it is contractually specified, whereas it would presumably be an eligible hedged risk in a non-financial item.

Citigroup recommends that the final standard permit hedging of further risks in line with common risk management strategies of enterprises. For example:

- In industry group discussions, we are aware of the view that the ED would not permit hedging of the rubber cost component in the purchase of tires due to the extensive production costs and the basis differences that those costs create. However, as explicitly stated in the ED, it would be possible to hedge the crude oil component of jet fuel (due to the market indices which reflect pricing of both commodities). Given that rubber costs are clearly a component part of the cost of tires, this disparity suggests that the current proposal is overly restrictive and rules-based (i.e., we do not understand why it is not possible to hedge where there is no market structure basis for the component of the pricing designated as the hedged risk – even if there is a clear conceptual link).
- Many corporate entities look to hedge expected increases in future salary costs due to inflation. This is a real business risk, which will impact cash flows, and which an entity may want to manage. Under the current proposal, it is unclear whether such a hedging strategy would be permitted.
- Many corporate entities also look to hedge the variability which is experienced due to changes in foreign currency exchange rates when the group has revenues and expenses (net income) in subsidiaries with functional currencies different to the group's functional currency. From an accounting standpoint, these business risks are generally designated using a Net Investment Hedge which addresses only the balance sheet exposures of the subsidiary. If the foreign currency denominated cash flows were received directly by the parent, they would represent a potential hedged item. We note that the overall risk for the reporting group is not different because the flows are received by the subsidiary, and so the overall group's risk management strategy may reasonably be expected to be identical regardless of where the cash flows are received. As such, this exclusion seems inappropriate.
- Many corporate entities have a stated risk management strategy to match the basis of their funding against the basis of their assets, and as such may wish to manage risk through the use of a basis swap (floating interest rate versus floating interest rate with different reference index). For example a company may hold a floating rate bond with 6-monthly resets, but predominantly fund itself through the short-term debt markets with 3-month commercial paper. As currently drafted, differences in floating rate bases are not permissible as a hedged item.

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?

Citigroup is broadly supportive of the proposals to allow hedging of a bottom layer of an asset or group of assets. We look forward to the more detailed guidance on macro-hedging regarding portfolios of financial assets with prepayment risk.

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 do not agree with the hedge effectiveness requirements proposed in the ED. In particular, we think that the requirement to consider and potentially adjust the hedge ratio each period to minimize expected hedge ineffectiveness is operationally burdensome, costly and unnecessary. Although the ED explicitly allows qualitative effectiveness testing in certain cases, we do not understand how qualitative assessment can ever be applied if the effectiveness test is based on the quantitative hedge ratio that is always expected to minimize hedge ineffectiveness.

Citigroup supports removing the 'bright line' rules for hedging ratios from the effectiveness criteria, commonly referred to as the 80-125% test. We also agree that effectiveness testing should reflect the entity's risk management activities, which may tolerate some hedge ineffectiveness. Please refer to Question 1 for further comments on the level of documentation of the entity's risk management strategies and Question 7 for comments on rebalancing.

Overall, we believe that the effectiveness requirements in the ED should be replaced with a qualitative analysis to demonstrate that the relationship provides an economic offset between the hedged item and hedging instrument. We would refer the Board to earlier proposals from the FASB, which we believe are far superior in terms of the assessment of effectiveness than the new concepts created in the ED.

Paragraph B35 in the exposure draft includes the term "magnitude," stating that "any value already reflected in a derivative at the point of designation into a hedging relationship does not mean that a qualitative test of effectiveness would not be appropriate, but that the continued appropriateness would be based upon the 'magnitude' of any ineffectiveness which this might cause". The term magnitude seems to have a very straightforward literal meaning – but is not defined in accounting terms in the standard, and therefore provides an opportunity for diversity in practice or for the creation of another bright line to replace the 80 – 125% corridor.

Although reducing the requirements for effectiveness may reduce the work of performing hedge effectiveness testing, the measurement process proposed in the ED would often be more complex and onerous than the existing requirements in IAS 39. For example, a common strategy is to assess hedge effectiveness based on changes in spot rates or cash prices, especially in hedging situations where the timing of the underlying exposure is uncertain within a specified time period. This is consistent with the current and proposed guidance that allows entities to separate the interest element and the spot price of a forward contract and designate as the hedging instrument only the change in the spot element of a forward contract and not the interest element.

The ED would require that the time value of money be considered in measuring hedge ineffectiveness. Requiring the spot component to be calculated on a discounted basis introduces significant practical issues. In many cases, companies do not have any way to predictably forecast the timing of the payments during the specified time period and therefore have no reliable way to define the appropriate hypothetical derivative, for example, when hundreds or even thousands of cash payments are made on capital projects. There could also be considerable ineffectiveness for companies who use shorter-dated derivatives due to credit or market constraints to hedge longer-dated exposures. We believe that entities should have the ability to assess hedge effectiveness and measure hedge ineffectiveness using spot risk on a non-discounted basis consistent with an exclusion of the interest element.

The requirement to measure changes in creditworthiness for both the actual derivative and the hypothetical derivative also creates significant practical issues. For example, how would a company measure changes in credit risk associated with forecasted FX revenues from ten customers or from 10,000? It may also be impractical for a company to measure the change in creditworthiness of forecasted purchases of electricity or corn sweetener or natural gas from small and perhaps local suppliers who do not have an observable credit default swap spread or credit rating. We believe it is critical that a final standard provide more practicable approaches to measuring hedge effectiveness, in particular for changes in creditworthiness.

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 find that this proposal is not clearly expressed in the ED, and there is unclear guidance on how it might align with the risk management objectives of the reporting entity. Further, the requirement to rebalance creates a number of practical and implementation issues. Citigroup believes that this guidance should be removed from the final standard, because the potential costs far outweigh any perceived benefits to financial statement users. In particular, we question what benefit a compulsory rebalancing would add for the reporting entity in a simple hedging relationship scenario such as debt hedged for interest rate risk with matching notional amounts. For any hedge where the terms of the hedged item and hedging instrument match perfectly or very closely, a qualitative assessment without the requirement to rebalance the hedge should be sufficient despite some ineffectiveness that is expected to occur due to the differences in measurement of the hedged item and hedging instrument.

In practice, risk management strategies often must be expressed with broad parameters, for example, that an entity should maintain interest rate risk within a certain range. Should compulsory rebalancing be required, we are concerned that the accounting literature will require an entity to trade to achieve rebalancing (i.e., create an incremental cost to the entity) simply to meet the hedge accounting rules, rather than to meet an actual risk management or business requirement.

We remain extremely concerned about how these requirements will be interpreted in different jurisdictions. Overall, the requirements in the ED are not clear and run a very real risk of bright-line rulemaking or significant inconsistencies in application.

Should the Board decide to retain these requirements, we request that further implementation guidance be provided to enforce a consistent differentiation between ineffectiveness being present in the relationship, but the relationship still achieving a reasonable hedging ratio as determined in the risk management strategy, versus persistent ineffectiveness which could require rebalancing. Furthermore, since the ED currently seems to require rebalancing for every hedging relationship each period, the Board should more clearly articulate the circumstances in which a rebalancing is actually required. Questions that we believe need to be addressed include:

- Is the Board's intent that only significant and persistently high levels of ineffectiveness should trigger a rebalancing? Or would nominal ineffectiveness or other 'normal' changes in the statistical relationship between the hedged item and the hedging instrument require rebalancing? Can the Board provide explicit guidance which will allow reporting entities to determine what would constitute a nominal level of ineffectiveness?
- If a reporting entity fails to rebalance a hedging relationship, does that trigger the loss of hedge accounting and potential restatement risk? It is not clear what processes should be followed if the hedging ratio is not rebalanced in such an instance (for example by purchasing a new derivative). Would there be a requirement to rebalance for accounting purposes only? Or would the act of not rebalancing effectively lead to a de-designation event (i.e., voluntary de-designations by proxy)?

- Can a qualitative analysis ever truly be sufficient, given that rebalancing is required to reach the “optimal” hedging ratio? Should the final standard provide a specific definition of what would qualify as “optimal”?
- The examples in the ED are focused solely on *quantity*, and not on for example timing. Would a change in the estimated date of a forecasted transaction require a rebalancing event where the maturity date of the derivative must be amended?

Question 8

(a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?

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

We believe this is a fundamental flaw in the ED. Refer to Question 1 for further comments on why hedge accounting should be elective, both at inception and for de-designation of a hedge accounting relationship, and Question 7 on rebalancing.

There is currently no explicit requirement in the ED that hedge accounting has to comply with the risk management strategy (i.e., we may have a risk management strategy to limit interest rate risk in a fixed rate bond portfolio, but there is no requirement to apply hedge accounting to that portfolio – hedging remains an elective model at inception). We indicate again that there are many different levels of risk management throughout a complex business, and would question how one is intended to prove that the risk management objective for a particular hedging relationship has, or has not, changed – thereby requiring a de-designation. If the overall risk management objective has not changed but the entity decides to use a different hedging strategy to manage the same risk (which would meet the same risk management objective), would the entity be precluded from dedesignating the first hedge in order to enter into a replacement hedge? The ED creates significant restatement risk and potential for “second-guessing,” for little or no determinable benefit to the financial statement user.

There are also practical inconsistencies introduced by the current model. For example, if the reporting entity terminates a derivative, the hedge is automatically de-designated (but termination will likely cost money in real terms due to the application of funding charges by the counterparty); because of this cost, most reporting entities would instead seek to close out derivative positions by entering into an offsetting trade (typically at minimal or zero cost). While risk management monitoring or strategies would consider the ongoing risk profile of the entity under either scenario as almost identical, the current proposal would not treat these two instances in the same way. Hedge accounting would be required to continue in the second situation.

We also note that the majority of financial institutions are risk taking entities, and will frequently take a view on expectations of future variables. For example, entities may wish to hedge interest rate risk where it is thought likely that rates will soon be rising and the entity owns fixed rate assets; but may wish to de-designate that hedge after a period of time if interest rates are thought to have peaked. The most cost effective method of hedging may be to utilize swaps to enter into hedges, and offsetting swaps to close out hedge positions (as opposed to using more expensive risk management trades like options). We do not believe the Board intends accounting standards to create real costs to the business for little or no determinable benefit (i.e., the risk management strategy would be the same regardless of the instrument used, but the cost of hedging could be very different).

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?

While we do not object to the proposals, we do not believe that posting the results of both the derivative and the hedged item to OCI provides useful information to the user of the financial statements. Since any difference between the two OCI amounts represents ineffectiveness that must be transferred to profit or loss, the two amounts remaining in OCI will be the same and net to zero.

We are concerned that the basis adjustment which, under the ED, is required to be presented as a separate line on the balance sheet does not meet the definition of either an asset or a liability. There are also significant practical concerns about tracking which balances are recorded within such an account at a complex institution where hedge accounting is used extensively. There are currently no systems in place which could track or monitor such an account on an ongoing basis. Citigroup recommends that the final standard carry over the existing requirements in IAS 39.

Question 10

- (a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalized into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

Overall, Citigroup strongly supports the proposed model where changes in an option's time value are recorded to Other Comprehensive Income. The rules under IAS 39 that require changes in an option's time value to be recorded immediately in earnings produce counterintuitive results, do not provide useful information to the users of financial statements, and have in practice driven hedging behavior in certain circumstances.

We believe the proposals in the ED could be improved and simplified and suggest the following:

- In order to avoid additional complexity in the hedge accounting model, we recommend that the names of these strategies be kept consistent with already established terminology. That is, a transaction-related hedge is a cash flow hedge, and a period-related hedge is a fair value hedge. The creation of two new terms (and resulting models) in the ED does not provide additional benefit.
- The approach for assessing and measuring ineffectiveness should be kept consistent with all other types of hedges.
- The proposals around "aligned time value" are complex and will be difficult to implement in practice. Even the simplified examples provided by the IASB on the project website are challenging to understand. As such, we request that clear implementation guidance be prepared and included in the final standard to demonstrate how these processes should function when implemented.
- To make the model operationally practicable, we would prefer the Board to introduce some practical expedients. For example, consistent with the FASB Exposure Draft on hedge accounting, where an option which settles on the 15th of the month is transacted to hedge cash flows which are expected to occur throughout the month, the FASB would allow the reporting entity to presume perfect effectiveness. This model would result in substantially similar results without the undue complexity and additional rule-making necessary in the IASB's ED. The further interplay with the rebalancing rules makes this an area where improvements are needed in a final standard.

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?

Citigroup agrees in principle that the Board is moving in the right direction, and look forward to the macro-hedging phase of this project to provide more details on hedging groups of items.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

We agree that it would be inappropriate to “gross up” the results of the derivative on several different lines on the income statement.

Question 13

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

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

The disclosures currently proposed are too voluminous and will overwhelm users of the financial statements. We recommend more tailored and focused disclosure requirements.

Disclosures of the entity’s risk management strategies for each category of risk which is subject to hedge accounting will also be determined by the level of the reporting entity at which that risk management strategy is controlled. For a global financial institution, this could result in extensive disclosure of micro-risk management strategies. See our response to Question 1 for more details.

Paragraph BC195(b) requests disclosures of information for each future period that a hedging relationship is expected to affect profit or loss. Citi has issued fixed-rate debt with maturities of greater than 30 years, and hedges that debt for interest rate risk with interest rate swaps. The ED would request disclosure for each of the next 30 or more years for our exposure to market price risk due to interest rate changes, the amount we are hedging out of that total, and how hedging changes that risk exposure. We do not think it is practicable to forecast our risk exposure for such a long period of time. Even for hedges that have much shorter maturities, forward looking quantitative data are necessarily subjective and subject to change; thus, we question the validity of including this information in the footnotes.

Question 14

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

We are broadly supportive of this principle, and consider it may be a useful practical expedient for some reporting entities.

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?

Citigroup believes that providing alternatives to hedge accounting through exceptions introduces significant additional complexity to the accounting for financial instruments. We do not agree with the Board's assertion that separating the credit component in the value of a loan or a loan commitment is unduly complex, and consider that credit should be an eligible hedged risk component. The final standard should provide principles-based requirements and, in our view, under those principles many economic hedges using CDS would qualify for hedge accounting.

Citigroup also believes that CDS are a form of purchased option, and the proposed guidelines around option hedging strategies could equally apply to purchased CDS. We recommend that the Board consider such an approach in more detail, as much of the conceptual work has already been completed through the proposals in the ED.

If the final standard does not permit management of credit risk in financial instruments with CDS under the hedge accounting model, we consider that these alternative proposals would be an improvement over the current IAS 39 model, regardless of the additional complexity involved. However, the model needs to be more principles-based, consistent with the risk management strategy of the reporting entity, and consistent with the hedge accounting objectives stated in the ED.

We are aware of other institutions which represent credit institutions (e.g. the International Association of Credit Portfolio Managers, or IACPM) that are very supportive of these alternatives. It is critical that credit managers be provided with appropriate accounting methodologies to represent risk management practices which are pervasive throughout the industry. As such, if the Board does not permit hedging using CDS under the standard hedge accounting models or the guidance on option hedging, we strongly recommend considering the views of the IACPM and other bodies in this area.

To address the proposals more specifically:

- Alternative 1: In our view, Alternative 1 is overly restrictive due to the requirement to elect the fair value option only at inception. We note that the proposed hedge accounting model remains elective and hedges may start at any time after recognition of the hedged item presuming that the hedges are supported by the risk management strategies of the entity. There are also obvious practical instances where high quality credit exposures could be purchased but could deteriorate significantly after initial recognition, alongside a risk management strategy which would require the purchase of financial instruments to mitigate credit risk for such exposures only if the credit quality deteriorates.
- Alternative 2: In our view, Alternative 2 does not provide significant additional benefit over Alternative 1 even though the ability to invoke the fair value option may be taken subsequent to the date of initial recognition. Should the entity elect the fair value option after initial recognition, the life-to-date gain or loss on the instrument is forced to the income statement directly, giving much the same result as if the instrument had always been at fair value since initial recognition. This retrospective application of the fair value election is consistent with neither the overall model for hedge accounting nor the fair value option under IFRS 9. It may also yield opportunities for the reporting entity to record gains in instances whereby, for example, the value of a fixed rate loan otherwise recorded at amortized cost has increased since origination due to movements in interest rates, or could incentivize firms against properly representing their risk management strategies in the income statement where loans have suffered losses since recognition even where CDS are subsequently used to manage credit risk.
- Alternative 3: Alternative 3 is our preferred approach, although we continue to consider that it remains limited. The ability to elect the fair value option after the date of initial recognition with the life-to-date fair value movement amortized to the income statement is the most consistent with the hedge accounting model presented. Please refer to our comments above which detail different approaches that we think merit consideration and are far superior to any of the alternatives presented.

Question 16

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

Citigroup agrees that the transition requirements for hedge accounting should be prospective. As hedge accounting is an elective model, and the designations are intention based, it would be inappropriate to include any element of retrospective application.

However, any transition should be considered in light of the partial retrospective application currently proposed under the recognition and measurement phases of IFRS 9. Those phases would currently require reporting entities to present comparatives on a mixed measurement basis – i.e., the new IFRS 9 requirements would be applied for instruments still held at the opening balance sheet date with application of the previous hedge accounting rules under IAS 39; the previous IAS 39 rules for recognition and measurement would be applied to items that are no longer held at the balance sheet date. It is critical that the final standard provide comprehensive transition guidance and examples that address the interplay between each phase of IFRS 9.

We would support the proposals already mentioned by other institutions to include a date of initial adoption (DIA) in the standard that coincides with the earliest date included in the comparative numbers. This would allow meaningful balances to be presented as comparatives and would accurately reflect the business intentions and risk management strategies employed throughout the period (including those relating to hedge accounting).