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Dear Madam, dear Sir,

ED/2010/13 Hedge accounting

The European Banking Authority (EBA), which has come into being as of 1 January 2011, welcomes the opportunity to comment on the IASB's Exposure Draft on Hedge Accounting (ED).

The EBA has a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA generally supports the orientation of the exposure draft which is considered to be an improvement in comparison to the hedge accounting provisions included in IAS 39. In particular we welcome the fact that the proposals are less rule-based.

On the whole we also support the intention to link the objective of hedge accounting to risk management practices. At the same time, it is important to stress that hedge accounting is not intended to reflect all risk management practices, but rather to reflect only those which aim at reducing or offsetting the impact in profit or loss (or OCI) of the entity's exposures to financial risks. To achieve this, the objective of hedge accounting (par. 1) should be consistently clarified.

It is also important that the hedge accounting framework is based on principles consistent with the newly defined objective. Against the background of the principles-based objective and intentions it is not clear why certain risk components – such as the risk component related to some prepayment options and 'sub-LIBOR' financial instruments - are ineligible for hedge accounting. In the same vein, we would encourage the IASB to reconsider its decisions regarding the eligibility of instruments that are not measured at fair value and instruments that are at fair value through OCI.

In terms of improvements, we welcome the developments regarding hedge effectiveness and the decision to remove the 'bright line' effectiveness test in favour of an objective-based assessment of effectiveness. Nevertheless, given that one objective of the exposure draft was to reduce complexity, the IASB should ensure that new concepts such as the effectiveness criteria and discontinuation/rebalancing are clearly explained and supplemented by adequate application guidance (these points are discussed further below). However both

concepts lead us to question whether the overall objective of the proposals – i.e. reducing complexity – has been met.

Finally, the EBA regrets that the proposals do not deal with macro-hedging, which is probably the most critical aspect of hedge accounting for the banking industry. Given the importance of this issue, the IASB should deal with this issue with some urgency, with the aim of developing an approach that is suitable for the banking industry and provides relevant information to users. In doing so, the IASB should aim for the best possible approach without feeling bound by the 'micro-hedging' conclusions that led to the ED under review.

If you have any questions regarding our comments, please feel free to contact Mr. Elbaum (+33.1.4292.5801) in his capacity as Chairman of the EBA Expert Group in charge of monitoring developments in the accounting area or Mr. Colinet (+ 32.2.220.5247) in his capacity as Chairman of the technical group that coordinated this comment letter.

Yours sincerely,

A handwritten signature in cursive script, appearing to read "Andrea Enria".

Andrea Enria
EBA Chairperson

Detailed questions

Objective of hedge accounting (paragraphs 1 and BC11–BC16)

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?

Objective of hedge accounting: better reflection of risk management practices in the financial statements

We broadly support the move towards a more principle-based approach and we consider that this ED would more closely align hedge accounting with risk management practices. As a consequence, the economic effects of hedging transactions should be reflected appropriately in the financial statements. In contrast to the current IAS 39 hedge accounting rules, the proposals in the ED would allow a reflection of the economic offset of significant hedging activities in the financial statements of both financial and non-financial institutions.

However, caution should be exercised so that the link between such activities and their reflection in the financial statements does not provide room for abuse such as earnings management. In this sense, hedge accounting should not aim to tell investors whether a hedging strategy is appropriate from a risk management perspective, but rather whether such strategy succeeds in offsetting the impact of a specific risk exposure in the financial statements.

Instruments at Fair value through OCI not eligible for hedge accounting

We disagree that hedge accounting cannot be applied to equity instruments measured at fair value through OCI and with the underlying rationale of the Board. Entities may apply economically sound hedging strategies to mitigate volatility in OCI. Moreover, we note that this restriction is merely explained by the interaction between phase I and phase III of IFRS 9 and the fact that, in that context, gains or losses in relation to equity instruments measured at fair value through OCI cannot be recycled to P&L.

As mentioned in our comments made in the context of phase I, we do not agree with the rationale used to justify the prohibition of recycling between OCI and profit or loss for equity instruments under IFRS 9, for the following reasons: (i) it would result in a misrepresentation of entities' performance in the income statement (ii) introduces undue volatility in profit or loss (to the extent that for an economic hedge of an item valued at fair value through OCI, the hedging instrument would have to be accounted for at fair value through profit or loss) and (iii) it discourages risk protection against equity risk.

Instruments that qualify for designation as hedging instruments (paragraphs 5–7 and BC28–BC47)

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?

In order to better reflect risk management activities in the financial statements we agree that hedging instruments should not be limited to derivative instruments since entities also use cash instruments as hedging instruments for risk management purposes.

We agree that only contracts with parties external to the reporting entity should be permitted to be designated in a hedge accounting relationship. We recognise that internal derivatives are used extensively for operational and risk management purposes, especially with respect to portfolio (macro) hedging, and will need to be analysed in the macro hedging project. However, even when these are employed, it is the contract with a party external to the reporting entity that is relevant for designation in hedge accounting relationships.

Whilst we recognise the potential complexities in developing a framework for the separation of risk components for designation as hedged items, we believe there is conceptual merit in this and it should be explored further.

Derivatives that qualify for designation as hedged items (paragraphs 15, B9 and BC48–BC51)

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 that such aggregate exposures should be eligible for designation as a hedged item, based on the rationale as described in the ED.

Designation of risk components as hedged items (paragraphs 18, B13–B18 and BC52–BC60)

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 (i.e. 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 Board's proposal to extend the hedged items eligible for hedge accounting such as non financial instruments, risks components, net positions, layer component of nominal amount.

We agree that separately identifiable and measurable risks should be eligible as hedged items regardless of whether they are financial or non-financial items. We recognise that the required identification and measurement will entail varying degrees of judgment; however, these concepts are well established in existing IFRSs and we view this as an acceptable consequence of moving away from a rules-based approach.

The ED maintains the restriction of IAS 39 which restricts the ability to apply hedge accounting with 'sub-LIBOR' financial instruments (paragraph B24 mentions "If a component of the cash flows of a financial asset or financial liability is designated as the hedged item, that component must be less than or

equal to the total cash flows of the asset or liability”). This restriction is not consistent with common risk management practices and more particularly with the provisions of the ED regarding designation of risk component as hedged items. We are notably concerned that this proposal could preclude financial entities from applying hedge accounting aligned to their risk management activities. Furthermore, this restriction is inconsistent with the principles-based objective adopted by the Board.

While acknowledging the difficulty in observing the inflation component in market inputs, the sensitivity of financial instruments to inflation is well identified by market participants. Therefore, we do not see the rationale for precluding inflation (not contractually specified) from hedge accounting.

Similarly, we do not see the rationale leading to the preclusion of a layer component of a contract that includes a prepayment option from hedge accounting.

Designation of a layer component of the nominal amount (paragraphs 18, B19–B23 and BC65–BC69)

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 agree that entities should be permitted to designate a layer component of a nominal amount as a hedged item on the basis of the rationale set out in the ED (BC68-BC69).

The prohibition with respect to prepayment options presumes that prepayment risk and interest rate risk cannot be separately measured. However, banking entities often have modeling techniques for prepayment risk for certain instruments which have proven sufficiently reliable to be incorporated into fair value estimates. Therefore we question whether this rule is necessary, within an otherwise principles-based standard. We also question why the existence of a prepayment option leads to ineligibility for a layer to be a hedged item but would still allow the entire nominal amount to be a hedged item.

We are also wondering whether this prohibition will have an impact on the decisions to be taken regarding the macro-hedge of portfolio for interest rate risk expected in the second sub-phase.

Hedge effectiveness requirements to qualify for hedge accounting (paragraphs 19, B27–B39 and BC75– BC90)

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

We support the simplification of the effectiveness test and notably the removal of the current quantitative threshold (80-125%) as it is arbitrary and not directly connected to an entity's risk management.

Given the removal of the 'bright line', we agree that the qualification and effectiveness assessment should be based on expected levels of effectiveness, an offsetting of hedged item and hedging instrument exposures, and an absence of deliberate bias. However, we have concerns that these requirements are not clearly articulated and leave room for varying interpretations. In particular: (i) in minimising ineffectiveness, an entity may be construed as ensuring that a hedge is highly effective, and (ii) achieving 'other than accidental offset' (whilst being an awkward way of expressing a requirement), requires a demonstrable economic relationship between relevant variables. The text in the requirements and application guidance should express these concepts more clearly as they are new and, accordingly, there are currently no best practices to draw from. Moreover, given the importance of these criteria, the IASB may want to consider moving this material from the application guidance to the main body of the standard.

Moreover, the standard should explicitly mention that any accounting change due to a modification of the hedge accounting policy should be documented beforehand. The IASB should clarify how to reconcile the request of assessing the effectiveness at the reporting date only on a forward looking basis and the recognition of ineffectiveness in profit and loss (which clearly requires looking back). In any case, it should be clarified that hedge effectiveness needs to be clearly documented.

Rebalancing of a hedging relationship (paragraphs 23, B46–B60 and BC106–BC111)

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?

Conceptually, the ability to rebalance is desirable as it enables re-alignment of the hedging relationship to the (unchanged) risk management objective when circumstances change (or are expected to change, in the case of proactive rebalancing), and provided that any ineffectiveness is previously recognised to profit or loss. Also, from a practical standpoint, it avoids the administratively cumbersome task of de-/re-designation.

While we agree with the decision-making logic that drives the decision to rebalance or discontinue, we are concerned that it is not clearly articulated in the ED, resulting in effectively a flexible choice between rebalancing and discontinuation. This is at odds with the proposal to disallow optional discontinuation, which we support (see our response to question 8). Because ineffectiveness will no longer be an objective measure (e.g. 80/125%), an entity will apply judgment in determining whether they need to consider rebalancing. Furthermore, if they determine that the hedge is no longer effective, then there is scope for 'retro-fitting' the risk management objectives in order to achieve a desired accounting outcome (discontinue or rebalance). Accordingly, the aim of the Board should be to clarify when rebalancing is appropriate. This could be aided by a disclosure requirement describing changes in risk management objectives that have had an impact on hedge accounting.

Taking into account this concern, the EBA considers important to specify in the main text of the standard that before any rebalancing, the hedge ineffectiveness has to be recognised in profit or loss. This concept is now expressed in Appendix B, par. B47: "on rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised in profit or loss immediately before adjusting the hedging relationship", but in EBA's opinion it should be upgraded in the main text of the standard.

Discontinuing hedge accounting (paragraphs 24, B61–B66 and BC112–BC118)

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?

In general the EBA agrees that discontinuation should be permitted only when the hedging relationship ceases to meet the qualifying criteria and the risk management objective has changed. In particular, it seems reasonable that entities are not allowed to discontinue at will or in order to achieve a desired result, which could lead to the possibility of earnings management.

However, as previously mentioned, it may become difficult to objectively define what the entity's risk management objectives and policies are - as also highlighted in the alternative view (AV5). The EBA is of the opinion that a robust model for deciding discontinuation should be required, and that more guidance on what a demonstrable and documented risk management strategy is would be extremely useful in this regard. More detailed disclosure in the notes for discontinued hedge relationships, requiring explanation of why and how the risk management objective has changed, would also help increase financial reporting discipline and make enforcement easier on this subject.

Accounting for fair value hedges (paragraphs 26–28 and BC119–BC129)

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?

We understand the rationale behind the proposed new accounting mechanism for fair value hedges and welcome a change that allows retaining the hedged item's measurement basis (e.g. amortised cost).

We believe that recording gains or losses on the hedging instrument and hedged item in OCI and transferring the ineffective portion to profit or loss provides better information on the extent of offset achieved by fair value hedges.

Whilst we support the presentation of the re-measurement amount of the hedged item as a separate line item, we are concerned about the proliferation of financial statement line items that may hinder the ability of users to understand the financial position of the entity.

Accordingly, the Board should consider aggregating similar re-measurement items and providing supporting detail in the notes.¹ This aggregation could be made for assets or liabilities that share the same nature or characteristics (e.g. by classes of financial instruments as defined in IFRS 7 or by distinguishing between financial instruments and non-financial items).

Conversely, we do not support linked presentation for the reasons set out in the ED.

¹ A technical concern arises regarding the option allowed to postpone amortisation of the separate line item (paragraph 28 of the ED), since this postponement would allow interpreting as hedge ineffectiveness P/L impact which in fact represents the lack of amortisation of the separate line item (accumulated hedge adjustments). In our opinion, a balance should be reached between conveying an adequate picture of the P/L impact (by amortising from the very moment when a fair value adjustment takes place) and the cost that such an approach would have in terms of the need to recalculate the effective interest rate. This balance could be achieved through the disclosure of both the amount of amortisation of the accumulated hedge adjustments and the amount of ineffectiveness.

In any case, the accounting mechanism proposed in the ED is superior to the one in IAS 39: in the ED, the "trade-off" is between amortisation of the accumulated hedge adjustment and ineffectiveness; whereas in IAS 39, the "trade-off" is between ineffectiveness and interest accrued.

Accounting for the time value of options for cash flow and fair value hedges (paragraphs 33, B67–B69 and BC143–BC155)

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 (e.g. 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 (i.e. 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?

Hedging strategies that involve the purchase of options permit an entity to protect against the downside risk of an exposure while retaining participation in any favourable changes. As explained in paragraph BC147 of the ED, this necessarily requires an external counterparty assuming the risk, with a corresponding cost. Since the option's time value represents such cost, we agree with the need to account for it in the same manner as an insurance premium.

However, by definition the time value of an option is subject to a time decay which increases as the option reaches its expiry date. Accordingly, for "time period related" hedged items we wonder whether the current IAS 39 approach (fair valuing the option's time value through profit or loss) and the ED proposal (amortising to profit or loss on a rational basis) substantially differ. In fact, the impact on profit or loss would remain practically unchanged to the extent that the cost of obtaining protection would be allocated over the relevant period most likely according to a similar pattern.

As regards "transaction related" hedged items, it seems rational to accrue the cost of insurance according to the general requirements.

Hedges of a group of items (paragraphs 34–39, B70–B82 and BC156–BC182)

Eligibility of a group of items as the hedged item (paragraphs 34, B70–B76, BC163, BC164 and BC168–BC173)

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?

On the whole, we are supportive of the criteria for the eligibility of groups of items as a hedged item, as they appear to be reflective of actual hedging practices. Also they seem to avoid artificial designations that currently can be

observed, such as designating an equivalent gross position instead of an actual net position.

Similarly to our response to question 7, there is, in this context, also a risk that an entity identifies suitable offsetting positions and documents that they are managed in a certain way, with the aim of changing the measurement basis, via hedge accounting. The Board should ensure that such practices are avoided, e.g. by imposing disclosure requirements describing changes in risk management objectives that have had an impact on hedge accounting.

Presentation (paragraphs 37, 38, B79–B82 and BC174–BC177)

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?

As mentioned in our response to question 9, the Board should consider aggregating similar re-measurement items and providing supporting detail in the notes. This is particularly needed in the light of the fact that the ED allows hedging groups of assets, groups of liabilities and groups of items that, for instance, combine both assets and liabilities.

At the same time, a detailed breakdown of the fair value gains and losses stemming from each hedging relationship of similar nature could be provided in the notes to the financial statements in order to convey adequate information to readers on the nature of such relationships and the extent to which the financial impact of the hedged exposures has been offset.

Regarding the presentation of cash flow hedges, and specifically when hedging groups of items with offsetting positions in the income statement, we agree that the hedging instrument's effect in profit or loss should be presented as a separate line item. To allocate this effect among all the different line items in which the income/expenses of each individual hedged item are recognised would not only distort the amount reported (see BC176) but also complicate the preparation of the financial statements.

Disclosures (paragraphs 40–52 and BC183–BC208)

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 EBA believes that sufficient and relevant disclosure is of utmost importance in financial reporting, and users would benefit from greater transparency and clarity regarding hedge accounting and its linkage with risk management strategies.

We support the proposed enhancement of the disclosures which will help users to better understand the risk management activities of the entities and the amounts included in the primary financial statements that are a result of hedge accounting. The Board should however clarify the interaction between the proposed disclosures and those of IFRS 7.

As the proposed disclosure is designed to provide information on risk management strategies we believe that disclosure of changes to risk management objectives during the period and the impact on financial statements would be useful. Furthermore, disclosure regarding the way in which management approaches and applies hedge effectiveness would aid users' understanding.

Accounting alternatives to hedge accounting (paragraphs BC208–BC246)

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative (Appendix C and paragraphs BC209–BC218)

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?

Our initial view is that we would not object to this approach. However we do have concerns, (similar to those discussed above) that more guidance is needed on this area.

Accounting for credit risk using credit derivatives (paragraphs BC219–BC246)

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?

Mitigating credit risk is a significant activity of banking entities. We note that the Basis for Conclusions accompanying the ED outlines the Board's rationale for not allowing hedging of credit risk as a separate risk component although this prohibition does not appear in the ED itself, unlike the inflation risk prohibition. The conclusion is based on the premise that separately measuring the credit risk component of a loan is complex. However, in practice, credit risk is often measurable and hedged by lending institutions. Because of this economically valid risk management strategy, the appropriate reporting for these practices should be explored further.

We are concerned that the Board did not sufficiently investigate this issue before deciding on this exclusion. We would therefore suggest that this is considered

further, taking into account the interaction with the project on impairment and supplementing the outcome by adequate disclosure requirements.

Effective date and transition (paragraphs 53–55 and BC247–BC254)

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 proposed prospective application from 1 January 2013.